0000004122

21

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

Arizona Corporation Commission
DOCKETED
JUN 30 2004
DOCKETED BY ne

MARC SPITZER, Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
MIKE GLEASON
KRISTIN K. MAYES

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS SUN CITY WEST WATER AND WASTEWATER DISTRICTS.	DOCKET NO. WS-01303A-02-0867
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS SUN CITY WATER AND WASTEWATER DISTRICTS.	DOCKET NO. WS-01303A-02-0868
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS MOHAVE WATER DISTRICT AND ITS HAVASU WATER DISTRICT.	DOCKET NO. W-01303A-02-0869
IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS ANTHEM WATER DISTRICT, ITS AGUA FRIA WATER DISTRICT, AND ITS ANTHEM/AGUA FRIA WASTEWATER DISTRICT.	DOCKET NO. WS-01303A-02-0870 DECISION NO. 67093 **OPINION AND ORDER**

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS TUBAC WATER DISTRICT.	DOCKET NO. W-01303A-02-0908

DATE OF HEARING:	November 5, 12, 13 and 18 (Public Comment); December 1 (Pre-Hearing), 4, 5, 8, 9, 10, 11, 12, 22 and 23, 2003.
PLACE OF HEARING:	Anthem, Surprise, Sun City, Bullhead City, Lake Havasu City and Tubac, Arizona (Public Comment); Phoenix, Arizona.
ADMINISTRATIVE LAW JUDGE:	Teena Wolfe
IN ATTENDANCE:	Chairman Marc Spitzer Commissioner William A. Mundell Commissioner Jeff Hatch-Miller Commissioner Mike Gleason Commissioner Kristin K. Mayes
APPEARANCES:	Mr. Jay L. Shapiro and Mr. Norman D. James, FENNEMORE CRAIG, P.C., on behalf of Arizona-American Water Company, Inc.; Mr. Walter W. Meek, President, Arizona Utility Investors Association; Mr. Frank J. Grimmelmann, in propria persona; Mr. Raymond E. Dare, President, Sun City Taxpayers Association; Mr. Paul R. Michaud, Mr. Larry K. Udall and Mr. William P. Sullivan, MARTINEZ & CURTIS, P.C., on behalf of the Town of Youngtown; Mr. Robert Taylor and Mr. Kenneth C. Sundlof, Jr., JENNINGS, STROUSS & SALMON, P.L.C., on behalf of Sun Health Corporation; Mr. Daniel Pozefsky on behalf of the Residential Utility Consumer Office; and Mr. Timothy J. Sabo, Mr. Gary H. Horton, Mr. Jason Gellman, Staff Attorneys, Legal Division, and Ms. Janice Alward, Assistant Chief Counsel, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

BY THE COMMISSION:

I. INTRODUCTION

A. Procedural History

On November 22, and December 13, 2002, Arizona-American Water Company, Inc. ("Arizona-American" or "Company") filed applications in the above-captioned dockets with the Arizona Corporation Commission ("Commission").

The applications request rate adjustments for ten districts owned by Arizona-American: Sun City West Water, Sun City Wastewater, Sun City Water, Sun City Wastewater, Mohave Water, Havasu Water, Anthem Water, Agua Fria Water, Anthem/Agua Fria Wastewater, and Tubac Water. These districts were previously owned and operated by Citizens Communications Company ("Citizens"). Arizona-American acquired these districts on January 15, 2002.[1] Arizona-American owns an additional wastewater district and an additional water district, but is not requesting a rate adjustment for those districts at this time. The wastewater district was formerly known as Sorenson Utility Company and was acquired from Citizens as part of the January 15, 2002 acquisition. The water district is the Paradise Valley Water District, which Arizona-American has owned and operated since the late 1960s.

On January 30, 2003, the Commission's Utilities Division Staff ("Staff") filed a letter in these dockets informing Arizona-American that the applications were sufficient.

On February 19, 2003, a Procedural Conference was held at the joint request of the Company, RUCO and Staff for the purpose of discussing the consolidation of the applications and other procedural matters, and on March 14, 2003, a Rate Case Procedural Order was issued consolidating the applications, setting the consolidated matters for hearing to commence on October 14, 2003, and

---

[1] The Commission approved the sale of Citizens' water and wastewater utility plant, property and assets in Arizona, and the transfer of Citizens' related Certificates of Convenience and Necessity to Arizona-American in Decision No. 63584 (April 24, 2001), and approved debt financing for Arizona-American's acquisition in Decision No. 64002 (August 30, 2001). On December 12, 2002, the Commission issued Decision No. 65453, which conditionally approved, under the Commission's Public Utility Holding Companies and Affiliated Interests Rules, A.A.C. R14-2-801 *et seq.*, a reorganization consisting of the merger of Arizona-American's parent, American Water Works Company, Inc., with a subsidiary of RWE AG. One condition of the Commission's approval was that Arizona-American refrain from filing any non-emergency rate increase requests for three years from the closing date of the reorganization. These consolidated rate applications were filed prior to the closing date of the reorganization, and thus are not subject to the conditions of Decision No. 65453. Arizona-American's appeal of Decision No. 65453 is pending in the Arizona Court of Appeals.

setting associated procedural deadlines.

Following a request by the Company and Staff to continue the procedural schedule, an Amended Rate Case Procedural Order was issued on June 6, 2003, continuing the hearing date to December 4, 2003, and accordingly extending the timeclock for a final Commission decision.

The Residential Utility Consumer Office ("RUCO"), Mr. Carlton G. Young, Mr. Frank J. Grimmelmann, Sun City Taxpayers Association ("SCTA"), the Town of Youngtown ("Youngtown"), Arizona Utility Investors Association ("AUIA"), Fiesta RV Resort Limited Partnership ("Fiesta"), and Sun Health Corporation ("Sun Health") were all granted intervention in this matter.

By Procedural Order of October 2, 2003, the Commission scheduled public comment open meetings in the affected Districts in order to allow customers to more conveniently provide public comment. Commissioners took public comment in Anthem on November 5, in Surprise and Sun City on November 12, in Bullhead City and Lake Havasu City on November 13, and in Tubac on November 18, 2003. Evidentiary hearings were conducted in Phoenix on December 4, 5, 8, 9, 10, 11, 12, 22 and 23, 2003. Closing briefs were filed on February 4, 2004 and reply briefs were filed on February 18, 2004.

B. Rate Applications

According to the Company's revised schedules, in the test year ended December 31, 2001, Arizona-American's ten requesting Districts had adjusted operating income of $5,156,336 on an adjusted reconstruction cost new less depreciation ("RCND") rate base of $136,190,641, an approximate 3.79 percent rate of return on RCND. Arizona-American requests a revenue increase of $8,246,082, for a 7.5 percent rate of return on its proposed RCND rate base of $136,190,641. The Company's request would increase revenue by approximately 27.58 percent for the ten requesting Districts.

By District, according to Arizona-American's revised schedules, adjusted test year operating income was as follows:

District	Test Year Adjusted Operating Income (Company)
Sun City West Water	$ 447,938
Sun City West Wastewater	($ 42,627)

Sun City Water	$ 581,339
Sun City Wastewater	$ 1,130,307
Mohave Water	$ 915,999
Havasu Water	$ 14,756
Anthem Water	$ 731,486
Agua Fria Water	$ 1,340,208
Anthem/Agua Fria Wastewater	$ 18,444
Tubac Water	$ 18,486
Ten District Total	$ 5,156,336

According to the Company's revised schedules,[2] in the test year ended December 31, 2001, the ten Districts' adjusted original cost rate base ("OCRB")[3] and RCND[4] rate bases were as follows:

District	Adjusted Test Year OCRB (Company)	Adjusted Test Year OCRB (Company, with Acq. Adj. Removed)[5]	Adjusted Test Year RCND (Company)
Sun City West Water	$ 20,165,548	$12,063,646	$ 15,432,917
Sun City West Wastewater	$ 19,236,443	$ 8,915,007	$ 12,221,084
Sun City Water	$ 31,686,119	$22,014,473	$ 44,279,756
Sun City Wastewater	$ 13,933,851	$ 8,709,672	$ 17,192,669
Mohave Water	$ 15,731,014	$ 9,656,133	$ 13,350,302
Havasu Water	$ 1,394,854	$ 875,573	$ 1,216,964
Anthem Water	$ 20,228,820	$ 9,267,853	$ 9,627,995
Agua Fria Water	$ 29,926,200	$16,722,762	$ 18,346,919

[2] Rejoinder Testimony Schedules B-1 for each District.
[3] Pursuant to A.A.C. R14-2-103(A)(3)(h), OCRB is "[a]n amount consisting of the depreciated original cost, prudently invested, of the property (exclusive of contributions and/or advances in aid of construction) at the end of the test year, used or useful, plus a proper allowance for working capital and including all applicable pro forma adjustments."
[4] Pursuant to A.A.C. R14-2-103(A)(3)(n), RCND is "[a]n amount consisting of the depreciated reconstruction cost new of the property (exclusive of contributions and/or advances in aid of construction) at the end of the test year, used and useful, plus a proper allowance for working capital and including all applicable pro forma adjustments. Contributions and advances in aid of construction, if recorded in the accounts of the public service corporation, shall be increased to a reconstruction new basis."
[5] The OCRB figures in the Company's Rejoinder Schedules B-1 included an acquisition adjustment for each District. As the Company stated in Direct Testimony, it is not requesting recovery on the acquisition adjustment (Exh. A-65 at 22), and the acquisition adjustment figures have been subtracted in this column.

Anthem/Agua Fria W/W	$ 8,819,139	$ 2,731,317	$ 2,789,661
Tubac Water	$ 1,653,394	$ 1,126,292	$ 1,732,373
Ten District Total	$162,775,382	$92,082,728	$136,190,640

By District, the Company's request would increase/decrease revenue by the following amounts:[6]

District	Requested Increase in Revenue	(Percent)
Sun City West Water	$ 1,156,931	34.22 %
Sun City West Wastewater	$ 1,565,307	44.27 %
Sun City Water	$ 4,453,775	71.92 %
Sun City Wastewater	$ 260,879	5.13 %
Mohave Water	$ 142,344	3.24 %
Havasu Water	$ 123,933	28.11 %
Anthem Water	($ 12,809)	(0.32 %)
Agua Fria Water	$ 62,372	1.01 %
Anthem/Agua Fria Wastewater	$ 311,419	16.68 %
Tubac Water	$ 181,931	71.49 %
Ten District Total	$ 8,246,082	27.58%

1. Acquisition Adjustment/Amortization

Decision No. 63584 (April 24, 2001), which approved Citizens' sale of assets to Arizona-American, ordered that future authorization of any acquisition adjustment recovery should be based on Arizona-American's ability to demonstrate that clear, quantifiable and substantial net benefits have been realized by ratepayers in the affected areas, which would not have been realized had the transaction not occurred.

As required by the National Association of Regulatory Utility Commissioners ("NARUC") Uniform System of Accounts, the Company has recorded the difference between the asset purchase price of Citizens' water and wastewater systems and their recorded book cost less depreciation, for

[6] Exh. A-24, Ex. 1.

accounting purposes (Exh. A-65 at 20; Exh. A-74 at 9-10, 14). In this proceeding, the Company has not attempted to prove the net benefits as required by Decision No. 63584; is not requesting recovery of its recorded acquisition adjustment; and states that it has not included an acquisition adjustment in its RCND rate base computation (Exh. A-74 at 10-11). Staff testified that if in the future Arizona-American requests recognition of an acquisition adjustment, the effect of lost accumulated deferred income credits of $4.6 million and investment tax credits of $1.9 million must be accounted for in the calculation of "net benefits" as required by Decision No. 63584, because the effect of the elimination of these items in the transfer of assets from Arizona-American to Citizens was an increase to rate base (Exh. S-47 at 20-21).

The Company requests authority at this time to deviate from the standard straight-line amortization accounting treatment of the recorded acquisition adjustment balance, and instead use a mortgage-style amortization method over 40 years (Exh. A-65 at 20). Arizona-American argues on brief that this would be beneficial because (1) the amount available for recovery in a future rate case, if requested, would be smaller; and (2) extinguishment of the acquisition adjustment from the Company's books would reduce controversy as to whether the adjustment constitutes an "original cost" if the utility were sold again in the future.

Staff's witness testified that until the acquisition adjustment is recognized, there is no asset to amortize (Tr. at 1492). We agree, and find that it is premature to consider the Company's amortization request in this proceeding.

II. RATE BASE

A. Plant in Service

1. Accumulated Depreciation on Unidentified and Not Used and Useful Plant

In aggregate for the ten Districts, Staff proposed an adjustment removing $2,270,531 from plant the Company recorded at the end of the test year. The adjustment included removal of a total of $1,737,746 of not-used-and-useful plant, with a corresponding $543,880 reduction to Accumulated Depreciation; and a total of $272,649 of unidentified plant, with a corresponding $109,792 reduction to Accumulated Depreciation. Arizona-American accepted Staff's plant-in-service adjustments, with its own adjustments to comport with its method of common plant allocations for each District based on year-end customer counts. The Company did not, however, accept all of Staff's adjustments to Accumulated Depreciation related to the not-used-and-useful and unidentified plant amounts. The Company states that Staff correctly removed the accumulated depreciation through December 31, 2001 on unidentified plant that was never afforded rate base treatment. The Company asserts, however, that not-used-and-useful plant that was never previously given rate base treatment should now be treated as abandoned. Treating such plant as abandoned would require that accumulated depreciation on that plant through December 31, 2001 also be removed from Accumulated Depreciation. The Company further asserts that unidentified plant and not-used-and-useful plant that was previously given rate base treatment should now be treated as retired, which would require Accumulated Depreciation to be reduced by the full original cost of that plant. The Company believes that a total additional $438,000 should be removed from Accumulated Depreciation.

Arizona-American argues that it only recently took ownership and simply could not have assessed the "usefulness" of every plant item before filing these consolidated applications; that it was Citizens' inaction that caused the plant to be improperly recorded as plant-in-service; and that if plant cannot be identified, the Company cannot attempt to place it back in service (Exh. A-24 at 5). Staff asserts that Arizona-American became fully responsible for the Citizens' assets, and any related records, upon closing of the sale; that it presumably conducted a due diligence investigation of the assets before buying them; and that Arizona-American should be held responsible for any inadequate Citizens records. Staff contends that in order to retire an asset, the asset's salvage value must be calculated, and that a retired asset must be shown as retired on a company's books.

We agree with Staff that Arizona-American became fully responsible for the Citizens assets, and any related records, upon closing of the sale. The Company did not demonstrate that the plant items in question were retirements. It did not calculate the salvage value of the assets for which the Company seeks retirement treatment (Tr. at 163), and did not know whether the assets in question were shown as retired on Arizona-American's books (Tr. at 220). Staff's accumulated depreciation treatment on the not-used-and-useful and unidentified plant was logical and appropriate. We will therefore accept Staff's adjustments to Plant in Service and corresponding adjustments to Accumulated Depreciation.

2. Half-Year Convention

The Company believes that RUCO's proposed use of the half-year convention would understate the Company's plant balances and rate base. Arizona-American already employs a half-month convention, whereby a plant item is treated as being placed in service on the 15th of the month it becomes operational (Exh. A-21 at 7). The Company agrees with RUCO that the half-year convention should be utilized absent a reason to depart from the usual methodology, but asserts that its use would be improper here. The Company contends that there is no reason to be less accurate than the Company's system allows for, and notes that like the Company, Staff did not utilize the half-year convention in this case. We agree with the Company, and will not adopt RUCO's proposed adjustment.

3. Mohave AIAC and CIAC Balances

RUCO proposed an adjustment correcting a discrepancy between the balances in Citizens' general ledger and the Mohave District application for advances in aid of construction ("AIAC"), and making a corresponding correction to the Mohave District's contribution in aid of construction ("CIAC") balance (Exh. R-1 at 10-11, Sched. TJC-3). These adjustments are appropriate and we will adopt them.

4. Allocation of Computer Equipment

Staff proposed an adjustment removing certain computer equipment from Arizona-American's rate base as not used-and-useful in a total amount of $592,003 with a corresponding decrease to Accumulated Depreciation of $40,759 (Exh. S-48 at 14-16). Staff recommends that its version of the allocation (using the Company's allocation basis) be adopted. The Company agreed that this adjustment was made in accordance with the Company's allocation methodology (Exh. A-24 at 4), and we will adopt it.

B. Property Tax Calculation

In calculating its proposed level of property tax expense, RUCO used the years 1999, 2000 and 2001 to calculate revenues (Exh. R-2 at 2). RUCO states that this method complies with the methodology set forth in the January 3, 2001 memo from the Arizona Department of Revenue property tax division ("ADOR") to "Arizona Water and Sewer Utility Companies" regarding

"Modification of Evaluation Formula." (*See* Exh. R-2, Ex. 1). The memo states that the methodology for valuation is the product of an agreement between ADOR and the Water Utilities Association of Arizona. The Company asserts, however, that 1999, 2000 and 2001 will never again be used by ADOR in determining property tax levels for the Company, and therefore RUCO's calculation understates property tax expense. The Company argues that proposed revenue increases should be considered in determining the appropriate level of property tax to be recovered through rates, and states that it calculated its proposed property tax expense using a methodology approved by the Commission in the *Arizona Water Company* Decision No. 64282 (December 28, 2001), and *Bella Vista Water Co.* Decision No. 65350 (November 1, 2002) (Exh. A-1 at 14).

Staff calculated property tax expense using its proposed adjusted test year revenues twice and its recommended revenues once to calculate a three year average of revenues. We agree with Staff that using only historical revenues to calculate property taxes to include in the cost of service fails to capture the effects of future revenue from new rates, and can result in an understatement or overstatement of property tax expense. RUCO's methodology, although it follows the methodology set forth in the January 3, 2001, memo from ADOR, is less accurate than the methodology utilized by Staff. The Commission's calculation of property tax expense for ratemaking purposes is not controlled by ADOR's January 3, 2001 memo. We accept Staff's methodology for the calculation of property tax expense in this case.

III. ORIGINAL COST RATE BASE

Based on the foregoing discussion, we adopt an adjusted OCRB for ratemaking purposes for the ten Districts of $90,861,823. By District, we adopt an adjusted OCRB for ratemaking purposes for the Sun City West Water District of $11,971,281; for the Sun City West Wastewater District of $8,916,017; for the Sun City Water District of $21,853,479; for the Sun City Wastewater District of $8,713,382; for the Mohave Water District of $8,791,741; for the Havasu Water District of $822,117; for the Agua Fria Water District of $16,665,182; for the Anthem Water District of $9,269,095; for the Anthem/Agua Fria Wastewater District of $2,731,868; and for the Tubac Water District of $1,127,661.

. . .

IV. RECONSTRUCTION COST NEW RATE BASE

As discussed above, Arizona-American submitted schedules reflecting both an OCRB and an estimated RCND rate base for each water and wastewater District in the consolidated applications. The Company revised its reconstruction cost new plant studies in response to Staff's criticism of its estimated reconstructed plant values to Staff's general satisfaction (Exh. A-51 at 4; Exh. A-21 at 19; Exh. S-39 at 3). All of the adjustments reflected in our determination of the OCRB are equally applicable to the Company's proposed RCND. With the changes in these adjustments necessary to restate them in terms of reconstruction cost new, we adopt an adjusted RCND for the ten Districts of $134,406,301. By District, we adopt an adjusted RCND for ratemaking purposes for the Sun City West Water District of $15,314,756; for the Sun City West Wastewater District of $12,222,469; for the Sun City Water District of $43,955,934; for the Sun City Wastewater District of $17,199,992; for the Mohave Water District of $12,132,752; for the Havasu Water District of $1,142,665; for the Agua Fria Water District of $18,283,746; for the Anthem Water District of $9,629,285; for the Anthem/Agua Fria Wastewater District of $2,790,224; and for the Tubac Water District of $1,734,478.

V. FAIR VALUE RATE BASE

In accordance with the Commission's usual practice when a utility files reconstruction cost new data in support of an application for a general increase in rates, Staff proposed a fair value rate base ("FVRB") for each District derived from the average of the RCND and OCRB. RUCO did not consider the RCND rate base in developing its recommended revenues for each District (Exh. R-7 at 8-12). Youngtown also advocates that OCRB alone should be used as FVRB (Exh. Y-5 at 9-11). Mr. Grimmelmann concurs with RUCO and Youngtown that the FVRB should be based solely on OCRB (Grimmelmann Br. at 5). SCTA believes that Staff and RUCO calculated their proposed rates using appropriate rate setting methodologies, and that they are fair and equitable (SCTA Br. at 1).

The Company requests that the Commission reject these FVRB recommendations and instead find its proposed RCND rate base to be its FVRB. Arizona-American contends that its RCND provides the best measure of the Company's FVRB, based on its assertion that the RCND provides a more accurate estimate than the OCRB of the current value of the Company's utility plant and property used to provide service. The Company believes this case is distinguishable from past cases in which the Company accepted the Commission's traditional method of determining FVRB, because there is recent purchase price evidence in this case (Co. Br. at 20-23). In Arizona-American's view, the use of RCND alone as the FVRB in this particular case is supported by the approximately $276.5 million price Arizona-American recently paid for the Citizens' water and wastewater systems and related assets (approximately $270 million for the assets that are the subject of this proceeding), which included an initial book acquisition adjustment of approximately $71 million (*See* Exhs. A-65 at 10; A-69 through A-73, Tab A). AUIA states that while it could be argued that the price Arizona-American paid in the arms-length transaction with Citizen represents the actual value of the Company's property, it agrees with Arizona-American that RCND is an acceptable proxy (AUIA Br. at 5).

A. Discussion

Arizona-American asserts that its arms-length agreement with Citizens to purchase the assets for approximately $71 million over book value provides evidence that the current value of the Districts' utility plant and property exceeds its original cost; that this fact precludes the use of an OCRB to set rates in this proceeding under the fair value standard (Co. Br. at 23); and that no party has provided a legitimate basis for using the average of OCRB and RCND to determine the Company's FVRB (Co. Reply Br. at 5).

AUIA charges that OCRB "has nothing to do with the actual value of the company's property" and that "book value is an accounting fiction that is unrelated to real value and is not responsive to the requirements of *Simms*" (AUIA Br. at 5).

The Company admits that its RCND estimates are not entirely accurate, stating that its proposed RCND understates the current value of its utility plant and property because it does not include a trended value for its real property, franchises, organizational costs and other intangibles; because trended (increased) AIAC and CIAC balances have been deducted from the RCND, in accordance with Decision No. 63584;[7] and because the RCND does not include any amount for the

[7] Decision No. 63584, which authorized Citizens' sale to Arizona-American, adopted the negotiated agreement between the Company and Staff regarding the imputation and adjustment, for ratemaking purposes, of Citizens' AIAC and CIAC balances at the time of the sale.

Districts' "value as a going concern." (Co. Br. at 21-22).

Arizona-American contends that the methodology Staff and RUCO advocate for determination of the Company's FVRB is based on historic cost rather than current value, and that it amounts to a "prudent investment" methodology, which the Company states contravenes the holdings of *Arizona Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415 (1959)("*Arizona Water*") and *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 294 P.2d 378, (1956)("*Simms*")(Co. Br. at 5-6, 8). The Company asserts that the fair value standard is based on the value of property and the prudent investment standard is based on the cost of property (*Id.* at 6-8); that fair value rate base is based on value determined at the time rates are set and prudent investment rate base is derived from the amount originally invested when the property was first devoted to public service (*Id.* at 9-10); and that under the fair value system, a utility will be entitled to a greater return when the value of property increases, but will also bear the risk that the value of its property may decrease (*Id.* at 10-12). The Company also cites *Arizona Water* for its holding that failure to determine fair value and provide for a fair return on property employed is a taking without due process of law.

Youngtown believes that the Company's request to use RCND as FVRB side-steps Decision No. 63584's requirement that recognition of any acquisition adjustment be supported by quantifiable benefits to ratepayers resulting from the acquisition (Youngtown Br. at 3). Youngtown argues that the purchase transaction was consummated after the issuance of Decision No. 63584, and that Arizona-American purchased utility assets with a known book value that were generating income based upon that book value. Youngtown charges that the Company concedes it has made no demonstration of acquisition benefits in this case; that the Company should not be allowed to do indirectly that which it is prohibited from doing directly; and that giving any weight to RCND will have that precise effect (*Id.* at 10-12). Youngtown contends that public policy mandates the exclusion of the Company's RCND estimates of plant value from the required fair value determination (Youngtown Br. at 7-8). Youngtown believes that the holding of *Cogent Pub. Serv., Inc. v. Arizona Corp. Comm'n*, 142 Ariz. 52, 688 P.2d 698 (App. 1984), which upheld the exclusion of contributed plant from FVRB, supports Youngtown's position that it is proper to look beyond the pure issue of cost and set FVRB based upon principles underlying general public policies (*Id.*).

RUCO agrees with the Company that the Commission is required to consider both OCRB and RCND evidence when determining FVRB (RUCO Br. at 3). RUCO objects, however, to the Company's proposed revenue requirement, which RUCO believes double-counts inflation; once in the cost of capital analysis, and again in the RCND rate base, resulting in a significantly overstated revenue requirement (*Id.* at 4, RUCO Reply Br. at 3). RUCO contends that the Company has failed to justify a departure from the traditional ratemaking formula for the use of a formula that will result in an overstated revenue requirement (RUCO Br. at 6-7).

Staff states that fair value is a flexible standard that includes consideration of original cost, and that *Simms* cannot be read to ban the use of original cost (Staff Reply Br. at 1-4). Staff argues that an OCRB does not violate the requirement of *Simms* and other cases holding that fair value must be determined "at the time of inquiry," because the OCRB varies over the course of time due to depreciation, retirements, etc. (*Id.* at 4). Responding to the Company's accusation that Staff uses the "prudent investment theory," Staff states that the prudent investment theory focuses on capital rather than assets, and that Staff looked to the original cost of the Company's assets rather than the invested capital (*Id.*). Staff contends that RCND is inherently speculative, "at best opinion evidence that carries the weakness of some inaccuracy" (*Id.* at 5, citing *Simms* at 153, 294 P.2d at 383) and should not be given great weight when other evidence of value, such as original cost, is available (*Id.* at 5). In response to the Company's contention that the purchase price paid for the assets supports the use of its estimated RCND, Staff states that the Company's witness on this point agreed that using the purchase price to set rates is circular (Tr. at 197-198), and that *Arizona Water* holds that the purchase price, standing alone, should not be considered in determining rate base (Staff Reply Br. at 6, citing *Arizona Water* at 203-04, 335 P.2d at 415).

B. <u>Conclusion</u>

We disagree with the Company's assertion that this Commission's traditional practice for determining fair value rate base amounts to the "prudent investment theory" discussed in *Arizona Water* and *Simms*. The OCRB methodology is based on current, verifiable and reasonable adjustments to a verifiable, objective record of the value of assets, and not on the original capital investment in those assets. In our consideration of all the relevant factors for our fair value determination in this case, we observe the Company's admission that its estimated RCND does not accurately reflect even its own view of the value of its assets, and agree with Staff's contention that RCND is inherently speculative. The Company argues that the price it paid for the Citizens assets supports the adoption of its comparable RCND estimate as the fair value of its utility property. We reject this argument. While the approximately $71 million over book cost price the Company freely chose to pay for the Citizens assets may represent the value of the acquisition to Arizona-American and its shareholders, it does not automatically follow that the price paid equates to the fair value of those assets for ratemaking purposes. Essentially, the Company's line of reasoning boils down to an argument that "market price" equals "fair value" for ratemaking, and this does not hold. From a ratemaking perspective, a change in ownership of assets devoted to public use should not change their fair value. As far as any ratemaking benefit that might result from a change in ownership, we addressed that issue in Decision No. 63584.

The Company dismisses RUCO's and Youngtown's arguments that Arizona-American is attempting to recover a return on an acquisition premium in this proceeding as "simply a red herring" (Co. Br. at 24). We accept the Company's argument that no line item "acquisition adjustment" appears in the Company's RCND calculations (*See* Co. Reply Br. at 10-11). However, we are in agreement with the premise of Youngtown's argument that accepting the Company's RCND estimates as FVRB in this proceeding would have the effect of granting the Company the benefit of the acquisition adjustment we addressed in Decision No. 63584 without the requisite showing of quantifiable benefits to its ratepayers resulting from the acquisition, as mandated by that Decision. At the time we issued Decision No. 63584, we believed it was in the public interest to require a demonstration that clear, quantifiable and substantial net benefits have been realized by affected ratepayers, which benefits would not have been realized had the transaction not occurred, prior to making those ratepayers responsible for acquisition costs. The Company did not attempt to make such a showing in this proceeding. We continue to believe that such a requirement serves the public interest, and will not allow what we believe would be an inappropriate indirect recovery of the acquisition adjustment through acceptance of the Company's RCND estimate alone as FVRB in this proceeding.

C. Fair Value Rate Base Summary

Contrary to the Company's assertion that no party has provided a legitimate basis for using the average of OCRB and RCND to determine the Company's FVRB, there has been no legitimate basis presented for departing from this traditional ratemaking methodology. We find that the average of the adjusted OCRB and RCND provides a reasonable measurement of the current value of the Company's property dedicated to public service. Based upon a 50/50 weighting of the OCRB and RCND, this Commission finds the FVRB at December 31, 2001 for the ten Districts to be $112,634,062. By District, we find that the FVRB for the Sun City West Water District is $13,643,019; for the Sun City West Wastewater District, $10,569,243; for the Sun City Water District, $32,904,707; for the Sun City Wastewater District, $12,956,687; for the Mohave Water District, $10,462,247; for the Havasu Water District, $982,391; for the Agua Fria Water District, $17,474,464; for the Anthem Water District, $9,449,190; for the Anthem/Agua Fria Wastewater District, $2,761,046; and for the Tubac Water District, $1,431,070.

VI. OPERATING INCOME

A. Corporate Overheads, Salaries and Wages

Arizona-American proposed pro forma adjustments to remove Citizens' test year corporate overhead allocations and salaries and wages and replace them with adjusted 2002 American Water Works overheads, Service Company charges, and salaries and wages. With its initial filing, the Company utilized estimates of the 2002 amounts, but later provided actual 2002 expense amounts. The Company proposes that expenses be based on the monthly average of the costs incurred between March and December of 2002, because it believes January and February were not representative of its administrative and general management processes (Tr. at 613-616).

Staff argued that the test year figures for Citizens' corporate overheads and service company charges and salaries and wages should be used because the 2002 figures are not known and measurable; the use of 2002 figures creates a mismatch between test year revenues, expenses, and rate base; the 2002 figures are imprudently high; and use of 2002 figures makes ratepayers responsible for a new owner's higher costs. Staff asserted that the Company's proposed adjustments increase expenses by $3.6 million.

The Company responded that although 2002 revenues increased over 2001 by $3.5 million, $2.7 million of that amount resulted from the fact that the Company removed surcharge-related revenues and expenses from its test year figures and the 2002 figures (Tr. at 1548-1551). The Company asserts that Citizens' test year corporate overhead allocations, service company charges, and salaries and wages were artificially reduced as a result of the pending sale of its assets to Arizona-American, and are not indicative of the expenses that Arizona-American will incur in connection with its operations on a going-forward basis. The Company's witnesses testified that the 2001 level of expenses reflected the fact that Citizens, in anticipation of the sale, had ceased all long-range planning for capital improvements, reduced staffing levels, postponed important management decisions and terminated information technology support, and that left unchanged, the situation would have impacted the utility's ability to maintain adequate service to ratepayers (Exh. A-35 at 7-8; Tr. at 284, 1603-1605).

RUCO agreed with the Company that expense adjustments are necessary to remove the Citizens' test year overheads, service company charge and salaries and wage level of expenses, and replace them with Arizona-American's expense levels (Exh. R-1 at 11, 12, 14; Exh. R-3 at 19-21; Exh. R-7 at 20-23). RUCO recommended that the Commission adopt its calculation of projected corporate overhead expense of $4,216,091 (Exh. R-3 at 23-24; Exh. R-4 at 9), which is based on the Company's actual January through December 2002 overhead levels. RUCO also recommended that the Commission adopt a Company-wide payroll expense capitalization rate, and not the 2002 capitalization factors for each system proposed by the Company (Exh. R-8 at 8-9), explaining that because the proportion of salaries and wages capitalized by an individual system can vary from year to year, a Company-wide average capitalization factor better captures the year-to-year ebb and flow of construction projects, and is more appropriate for setting rates on a going-forward basis (*Id.*).

For ratemaking purposes, adjustments must be made to actual test year data to reflect known and measurable changes and to obtain a normal or more realistic relationship between revenues, expenses, and rate base, so that rates can be designed to reflect a normalized, realistic, and reasonable cost of providing service based on current conditions. We agree with the Company and RUCO that it is the known and measurable 2002 Arizona Water Works overheads, Service Company charges, and salaries and wages that Arizona-American will incur during the period the rates are in effect. We do not find Staff's argument that the higher 2002 costs are solely the product of the utility's new ownership a convincing reason to place artificially reduced expenses in rates. We find RUCO's recommended expense levels for corporate overheads, Service Company charges, and salaries and wages to be reasonable, and will adopt them.

B. Rate Case Expense

Arizona-American is requesting recognition of $715,000 in rate case expense amortized over three years (Exh. A-74 at 23). The Company did not provide a breakdown of rate case expense other than its estimate that the Company's total rate case expense will be between $1.3 million and $1.4 million. The Company based this estimate on the amount of expenses incurred through November 2003 of over $1 million according to its representation, exclusive of legal costs incurred in November 2003, any costs incurred during the month of December, and all post-hearing costs (Tr. at 1593).

The Company's witness stated that despite the increase in its expenses over its original request of $715,000, it is not requesting recognition of additional rate case expense (*Id.*). RUCO, the only party to dispute the Company's request, asserts that the Company failed to mitigate its rate case expense and that the Company's request is unreasonable. RUCO contends that the Company's excessive rate case expense is the result of the Company choosing a 2001 test year and the Company's choice to mount legal arguments for a deviation from this Commission's long-standing formula for determining revenue requirement. RUCO believes that the shareholders, and not the ratepayers, should be responsible for the resulting excess expense.

RUCO stated that while the Company's purchase of Citizens' assets formally closed on January 15, 2002, the Company chose the period ending December 31, 2001 as its test year, which resulted in the costly situation that all the data to support the Company's rate case proposal was held by another company, Citizens, which no longer existed and no longer had any employees. RUCO pointed out that this required an audit of two companies, both Arizona-American and Citizens, and that the Company could have reduced the work required if it had waited to file this rate case until it could use a historical test year based on its own operations. Regarding the expense required for the

Company to pursue its novel legal argument regarding this Commission's means of determining revenue requirement, RUCO stated that it is not suggesting that the Company be denied the right to present such an argument. RUCO contended, however, that ratepayers should not be charged for the Company's choice to incur the expense necessary to present the unorthodox argument, and that the amount of allowable rate case expense should therefore be reduced.

RUCO stated that this Commission has reduced a company's proposed rate case expense based upon a determination that the amount of expense requested is unreasonable citing Decision No. 59079 (May 5, 1999), wherein Paradise Valley Water Company's proposal for rate case expense was reduced because it exceeded its previous rate case expense by 75 percent. RUCO compared the rate case expense allowed in Citizens' previous rate case to Arizona-American's request in this case (*See* Decision No. 60172 (May 7, 1997)). RUCO stated that Citizens had argued there that its proposed expense of up to a "cap" of $750,000 was justified because that joint application included six rate cases; a very large number of intervenors and data requests; the CAP water issue which required the retention of water resources experts; and the retention of consultants in the area of rate design and price elasticity (*See id.* at 31). Citizens was allowed its original estimate of $366,231 in rate case expense in that case (*Id.* at 31). In coming to its rate case expense recommendation in this case, RUCO began with the amount of rate case expense allowed to Citizens in Decision No. 60172, and adjusted it by the Consumer Price Index factor to reflect current prices (Exh. R-7 at 26, Sched. MDC-13). RUCO believes that its resulting recommendation of $418,941, while still significantly higher than what the Commission has historically awarded water companies, is reasonable under the circumstances of this case. Only the Company disputed RUCO's proposal.

The Company agreed that its rate case expense for this proceeding is high, but argued that the expense is not large on a per-customer basis. As a justification for its costs, the Company argued on brief that it is not responsible for, and has little control over, the process utilized by this Commission for setting rates; that rate case proceedings are complex and involve a substantial expenditure of resources, with the applicant utility bearing the burden of proof; that there were compelling reasons requiring the filing of this case using a 2001 test year; and that RUCO did not cite any evidence to illustrate the impact on rate case expense of the Company's position on fair value rate base. The

Company asserted that its selection of a 2001 test year did not have an undue impact on the level of rate case expense and that the majority of the activity leading to rate case expense would have been unchanged if the Company had delayed its filing. The Company argued that under its requested recovery, its shareholders will absorb nearly half the rate case expense because the Company is only requesting recovery of $715,000. The Company also argued that RUCO's methodology ignores the fact that this Commission authorized rate case expense of $165,000 in Decision No. 56806 (February 1, 1990) which involved Citizens' two Mohave districts.

The Company's Director of Rates and Planning for the five western states of American Waterworks, testified that ". . . in this case, with the number of cases that this company has going on at one particular time, we did not have the resources on hand to handle a whole lot of the case ourselves." (Tr. at 375). As explained in the recent *Arizona Water Company* Decision No. 66849 (March 19, 2004), while we do not believe it is unreasonable *per se* for a company to retain outside counsel or consultants to prepare and litigate its rate case filings, at some point the utility must mitigate the costs associated with retaining those services. In addition, we agree with RUCO that the Company chose the test year for its application, and we believe that ratepayers should not be made to bear the burden of the Company's choices to incur unreasonable increases in expenses.

Based on our review of the complexity of this proceeding, the number of systems involved in this rate request, and a comparison of other cases, we find that rate case expense in the amount of $418,941 is reasonable for this proceeding.

1. Amortization of Rate Case Expense

The Company's proposed three year amortization of rate case expense was accepted by the other parties with the exception of Youngtown. Youngtown does not contest the $715,000 in rate case expense requested by the Company, but recommends a five year amortization period based upon the time between rate cases historically. Youngtown argues that rate case expense will be recovered in rates until new rates are set, from new customers as well as test-year customers, and that if the system experiences growth or if a rate case is not filed within the amortization period, the Company may overcollect this expense. Youngtown therefore believes that a five year amortization period is appropriate. Arizona-American responds that Arizona-American's track record of filing rate cases demonstrates that it files rate cases much more frequently than Citizens did. Arizona-American also states that the new federal arsenic treatment requirements will require a significant plant investment prior to January 1, 2006, or in less than three years, which will likely lead to new rate cases being filed in less than five years. The Company's pre-filed testimony states that the Company is likely to file its next rate case at the earliest possible date (Exh. A-74 at 24-25), and a Company witness testified at the hearing that the Company would be back in three years (Tr. at 365). Based on the testimony in this case, it is reasonable to expect that the Company will file a new rate case sooner than Youngtown's proposed amortization period of five years. Consistent with recent decisions, Arizona-American's rate case expense will therefore be amortized over three years.

C. Statement of Operating Income

In accordance with the discussion above, the adjusted test year operating expenses for ratemaking purposes for the ten Districts are $30,267,446. The adjusted test year operating expenses by District are $2,939,251 for the Sun City West Water District; $3,530,198 for the Sun City West Wastewater District; $5,678,120 for the Sun City Water District; $4,064,206 for the Sun City Wastewater District; $3,408,004 for the Mohave Water District; $415,213 for the Havasu Water District; $4,937,096 for the Agua Fria Water District; $3,235,919 for the Anthem Water District; $1,828,223 for the Anthem/Agua Fria Wastewater District; and $231,216 for the Tubac Water District.

Based on the foregoing, the adjusted test year operating income for the ten Districts is $5,083,368. The adjusted test year operating income by District is $441,523 for the Sun City West Water District; $5,482 for the Sun City West Wastewater District; $514,970 for the Sun City Water District; $1,024,134 for the Sun City Wastewater District; $986,128 for the Mohave Water District; $25,711 for the Havasu Water District; $1,248,941 for the Agua Fria Water District; $774,886 for the Anthem Water District; $38,323 for the Anthem/Agua Fria Wastewater District; and $23,270 for the Tubac Water District.

VII. COST OF CAPITAL

Arizona-American, Staff and RUCO presented cost of capital analyses for purposes of determining a fair value rate of return in this proceeding. Arizona-American's witness, Dr. Thomas

Zepp, determined an overall cost of capital of 7.51 percent. Staff is recommending, based on the analysis of Staff witness Joel Reiker, a cost of capital of 6.5 percent. Based on the analysis of its witness William Rigsby, RUCO believes the Commission should adopt RUCO's recommended 6.77 percent cost of capital.

A. Capital Structure and Cost of Debt

1. Capital Structure

The Company, Staff and RUCO recommend similar capital structures. The Company recommends 60 percent long-term debt and 40 percent common equity; Staff recommends long-term debt of 60.1 percent and common equity of 39.9 percent; and RUCO recommends long-term debt of 59.89 percent and common equity of 40.11 percent (Exh. A-74 at 25-27 and Ex. 3; Exh. S-46 at 28; Exh. R-5 at 38). We find Staff's recommendation of 60.1 percent long-term debt and 39.9 percent common equity reasonable and adopt it.

2. Long-Term Debt

While the Company and RUCO agree that Arizona-American's cost of long-term debt should be set at 4.86 percent (Exh. A-75 at 23; Exh. R-6 at 4), Staff disagrees. Staff updated its recommended cost of debt to 4.77 percent in its surrebuttal testimony, based on the debt structure represented to Staff in the Company's response to a data request in Docket No. W-01303A-03-0572, an Arizona-American request for financing authority (Exh. S-46 at 28, Sched. JMR-S17). Staff recommended that its cost of debt based on the information provided by Arizona-American be adopted. The Company claims that Staff failed to present a capital structure containing the specific amounts of debt and equity it recommends, and argues that Staff's capital structure and the resulting weighted cost of capital must be rejected. However, Staff's testimony included a schedule depicting the dollar amount of Arizona-American's debt (Exh. S-46, Sched. JMR-S17). Because Staff's updated recommended cost of debt is based on all of Arizona-American's debt, we will adopt 4.77 percent as the cost of debt in this case.

B. Cost of Equity

Although the cost of debt can be determined from fixed cost rates, the cost assigned to the equity component of the capital structure can only be estimated. The cost of equity recommendations advocated by the parties are 11.5 percent by Arizona-American, 9.61 percent by RUCO and 9.0 percent by Staff. The recommendations of the Company, RUCO and Staff all include a 50 basis point adder to account for the fact that Arizona-American is more leveraged than the sample water utilities included in the witnesses' analyses.

1. Positions of the Parties

a. Arizona-American

In determining its recommended rate for common equity, the Company's cost of capital consultant, Dr. Zepp, used the discounted cash flow ("DCF") model and three different risk premium models to estimate benchmark equity costs with data for publicly traded water and gas utilities. He also presented evidence based on the capital asset pricing model ("CAPM"), but gave those estimates no weight. Dr. Zepp found the current equity cost for his benchmark utilities to be in the range of 10.0 percent to 10.5 percent (Exh. 40-49 at 5, 6, Update Tables 13, 18), based on his application of the DCF model and an average of two forward-looking measures of growth. His analysis also included a restatement of Staff witness Mr. Reiker's DCF estimates based on the constant growth model. Dr. Zepp is of the opinion that Staff's DCF analysis is flawed because it uses dividends per share ("DPS") which, according to Dr. Zepp, is the worst measure of average future growth when earnings per share ("EPS") are growing more rapidly. Dr. Zepp's restatement of Mr. Reiker's constant growth DCF estimates without DPS growth in the average resulted in an equity cost in the range of 9.6 percent to 9.9 percent based on data in Mr. Reiker's direct testimony and 9.6 percent to 9.8 percent based on data in Mr. Reiker's surrebuttal testimony (Exh. A-49 at 47, Tables 10, 11; Exh. A-50 at 10-11, Tables 3, 4). Dr. Zepp performed another restatement of Staff's DCF by including a second stage that he claims properly reflects investors' expectations that future growth will be higher than current DPS growth when DPS are growing more slowly than EPS (Exh. A-49 at 47-50, Tables 8, 9; Exh. A-50 at 11-13, Tables 1, 2). As an exhibit to his rejoinder testimony, Dr. Zepp presented an e-mail from Myron Gordon, an authority on the DCF model, which he believes supports the inclusion of this second stage (Exh. A-50, Ex. TMZ-RJ-2). Based on his restatement of Staff's multi-stage DCF model, Dr. Zepp calculated the equity for the sample companies to be 10.1 percent at the time Mr. Reiker prepared his direct testimony and 10.0 percent to 10.1 percent at the time he prepared his surrebuttal testimony (Exh. A-49 at 49-50; Exh. A-50 at 12).

Dr. Zepp also restated RUCO's witness Mr. Rigsby's DCF results by increasing Mr. Rigsby's estimate of VS (external) growth by increasing the forecast of the growth in the number of shares of common stock expected to be issued by water utilities (Exh. A-49 at 51-53). Dr. Zepp also restated Mr. Rigsby's DCF model results using estimates of future VR (sustainable) growth and VS growth presented by Mr. Reiker (Exh. A-49 at 53, Table 13). With these two separate restatements of Mr. Rigsby's DCF model, Dr. Zepp calculated a DCF estimate for the benchmark water utilities that fell in a range of 10.1 percent to 10.9 percent. Dr. Zepp's restatements resulted in a cost of equity for the benchmark water utilities in a range of 9.6 percent to 10.9 percent.

Dr. Zepp performed three different risk premium analyses with cost of equity results in a range of 10.3 percent to 11.2 percent. According to Dr. Zepp, the CAPM analyses conducted by Staff and RUCO failed to include separate risk premium estimates. Dr. Zepp prefers a "zero-beta" version of the CAPM, which produced results showing that low-beta stocks like water utilities require higher returns (Exh. A-49 at 35). Dr. Zepp performed a restatement of Staff and RUCO's CAPM analyses, using forecasted values for long-term treasury bonds. Based on this restatement, Dr. Zepp calculated the cost of equity for the benchmark water utilities to fall in a range of 9.8 percent to 11.3 percent at the time Mr. Reiker prepared direct testimony, and in a range of 9.8 percent to 10 percent when Mr. Reiker updated his CAPM estimates in surrebuttal testimony (Exh. A-49 at 37-38; Exh. A-50 at 13, Tables 3, 4).

Apart from the technical analysis of the Staff and RUCO recommendations, Arizona-American claims that those analyses are inconsistent with recent authorized returns on common equity, realized returns on common equity, and *Value Line's* forecasted return on common equity. Dr. Zepp prepared a rebuttal schedule containing the authorized, realized and forecasted returns based on Staff's sample group of publicly traded water utilities from 1997 through 2003. His table shows average authorized returns for those years of 10.59 percent, realized returns of 10.61 percent, and forecasted returns of 10.9 percent (Exh. A-49, Table 1). The Company argued that those results show that the Staff and RUCO cost of equity estimates of 8.5 percent and 7.99 percent are substantially below the returns of the sample group of water utilities, and that the average cost of equity estimates of 10.5 percent to 10.8 percent produced by Dr. Zepp's model more accurately reflect the actual and forecasted cost of equity performances for comparably situated water companies. The Company also argues that Staff's rate of return recommendations, when applied to Staff's recommended fair value rate bases, are below the cost of the November 5, 2003 ten-year Treasury Rate, the forecasted 2004 ten-year Treasury Rate, the November 5, 2003 long-term Treasury Rate, and the forecasted 2004 long-term Treasury Rate (Exh. A-50, Rej. Table 6). The Company argues that because the yield on intermediate and long-term Treasuries is frequently used in the CAPM as the proxy risk-free rate, Staff's recommendation produces returns that are less than the return on a risk-free security.

Arizona-American also argues that the rates of return recommended by Staff and RUCO fail to satisfy the capital attraction standard and fail to ensure Arizona-American's financial integrity. The Company asserts that Staff's recommended rate of return results in pre-tax interest coverage of approximately 1.0 (Exh. A-74 at 30-31), in contrast to Staff's argument that Staff's recommended rate of return results in a pre-tax interest coverage ratio of 3.2 (Exh.S-46 at 29).

b. Staff

Staff's witness Reiker performed both CAPM and DCF analyses in arriving at Staff's 9.0 percent cost of equity estimate. Mr. Reiker explained that because Arizona-American stock is not publicly traded, Staff applied both these models to the six publicly traded water companies that have a significant percentage of revenue derived from regulated water utility operations and are currently followed by *The Value Line Investment Survey* and *The Value Investment Survey Small and Mid Cap Edition* (Exh. S-45 at 9, Sched. JMR-1). Mr. Reiker's analysis also included the cost of equity of ten sample gas companies which he states are riskier than water companies (Exh. S-45 at 26, Scheds. JMR-13-19). Staff's witness calculated both constant growth DCF and non-constant growth (multi-stage growth) DCF estimates (*Id.* at 10). He explained that the DCF method is based on the theory that a stock's market price is equal to the present value of all expected future dividends (*Id.* at 9). The constant growth DCF model assumes that a company has a constant payout ratio and that its earnings are expected to grow at a constant rate, while the multi-stage DCF model does not assume that dividends grow at a constant rate over time (*Id.* at 10-11). Application of the DCF formula uses three variables: 1) expected annual dividend; 2) current stock price; and 3) expected infinite annual growth rate of dividends. The expected annual dividend is divided by the current stock price and the result (the dividend yield) is added to the expected infinite annual growth rate of dividends, yielding the cost of equity estimate (Exh. S-45 at 11).

In establishing the stock price component of the DCF formula, Staff used the spot market price, in accord with the efficient markets hypothesis (Exh. S-46 at 7). Staff cited the *Black Mountain Gas Company* Decision No. 64727 (April 17, 2002) in support of its position that spot market price should be used as the current stock price for determining cost of equity.[8] Using the spot market price, Staff calculated dividend yield at 3.44 percent (Exh. S-46 at 3, Sched. JMR-S7). In estimating its growth variable, Staff examined historical and projected growth in dividends per share, growth in earnings per share, and intrinsic growth (Exh. S-45 at 12). Staff's analysis produced an average of the historic and projected growth rates of 4.98 percent (Exh. S-46 at 3, Sched. JMR-S4), which when added to Staff's dividend yield calculation, produced Staff's constant growth DCF estimate of 8.4 percent (*Id.*, Sched. JMR-S7). The multi-stage DCF model incorporates at least two growth rates to account for the assumption that investors expect a certain rate of non-constant dividend growth in the near term (Stage 1 Growth), as well as a longer-term constant rate of growth (Stage 2 Growth). Staff used *Value Line* information concerning its six sample water companies and reached a multi-stage DCF estimate of 9.6 percent. Averaging the results of its constant and multi-stage DCF estimates, Staff arrived at an overall DCF estimate of 9.0 percent (*Id.*, Sched. JMR-S7).

Mr. Reiker testified that the best known model of risk and return is the capital asset pricing model ("CAPM"), which states that the expected return on a risky asset is equal to the sum of the prevailing risk-free interest rate and the market risk premium adjusted for the riskiness of the investment relative to the market (Exh. S-45 at 21). The CAPM requires the input of the following variables to arrive at an estimate of a company's equity cost: 1) the risk free rate; 2) the return on market; 3) the risk variable or "beta;" and 4) the market risk premium (*Id.* at 22). Staff based its estimate of the prevailing risk-free rate on the average of intermediate-term U.S. Treasury securities' spot rates as published in *The Wall Street Journal*, and calculated both a historical market risk

[8] Use of spot market price was also adopted in the recent *Arizona Water Company* Decision No. 66849 (March 19, 2004).

premium and a current market risk premium to determine its market risk premium estimate range (Exh. S-45 at 22-25). Staff derived its data from the average of the *Value Line* beta for the six proxy water utilities. The average beta computed to .59 for the companies (*Id.* at 23, Sched. JMR-6). Mr. Reiker stated that the market risk premium represents the additional return an investor expects for investing in the market (or an average-risk security) over the investor's expected return for investing in a risk-free asset security (*Id.* at 23). Staff's historical market risk analysis resulted in a risk premium of 7.4 percent, while its current market risk premium analysis resulted in a risk premium of 7.6 percent (Exh. S-46, Sched. JMR-S7). Staff's CAPM analysis results in an equity cost estimate for Arizona-American of 8.1 percent (*Id.*). Staff reached its overall cost of equity determination of 8.5 percent by averaging the results of its constant growth and multi-stage DCF analyses, which produced a result of 9.0 percent, and its CAPM result of 8.1 percent (Exh. S-46 at 2). As discussed above, Staff, along with the Company and RUCO, recommends adding 50 basis points to its estimate to account for the Company's debt-heavy capital structure as compared to the sample water companies. Staff's resulting recommendation is a 9.0 percent cost of equity (*Id.*).

Staff also averaged the DCF and CAPM for the proxy gas companies, which resulted in an equity cost estimate of 10.3 percent for those companies (Exh. S-45 at 26). Staff states that based on its CAPM analysis, the cost of equity to the sample gas companies is approximately 100 basis points higher than the cost of equity to the sample water companies, based on the difference in risk, and that Staff's estimate of the cost of equity to the sample gas companies would require a significant downward adjustment in addition to a capital structure adjustment in order to be applied to Arizona-American (*Id.*).

c. <u>RUCO</u>

RUCO witness Rigsby recommends a cost of capital of 6.77 percent, based on his cost of common equity calculation of 9.61 percent (Exh. R-6 at 10). Mr. Rigsby based his cost of equity recommendation on his DCF analysis result of 9.11 percent for cost of equity (Exh. R-5, Sched. WAR-3), which, with the agreed-upon 50 basis point adder, resulted in a recommendation of 9.61 percent (Exh. R-6 at 10). Mr. Rigsby also performed a CAPM analysis which produced results ranging from 6.79 percent to 8.06 percent (Exh. R-5 at 28, Scheds. WAR-8, 9). RUCO believes that its cost of common equity recommendation is reasonable and appropriate given Arizona-American's current operating environment of low inflation and low interest rates (Exh. R-6 at 7-8, 14). RUCO takes issue with the Company's claim that RUCO and Staff's recommended returns on equity would be confiscatory under the comparable earnings standard, which compares returns being earned by companies with corresponding risk, stating that the comparable earnings methodology has been discredited for almost two decades (Exh. R-6 at 5). On brief, RUCO cited a recent case involving a sister water company of Arizona-American, West Virginia-American Water Company (Commission Order, Public Service Commission of West Virginia, Charleston, Case No. 03-0353-W-42T, January 2, 2004). RUCO noted that the Public Service Commission of West Virginia approved a 7.0 percent cost of common equity for the West Virginia affiliate of Arizona-American, noting that the company's 10.0 percent to 11.5 percent return on equity recommendation was outside the range of reasonableness (*Id.* at 20-21), and that its 7.0 percent return on equity determination balanced the concerns of the company regarding investor perception regarding the riskiness of the water industry with the need to insure that the ratepayers pay rates reflecting no more than a fair rate of return while still complying with the *Hope*[9] and *Bluefield*[10] decisions (*Id.* at 21).

d. <u>AUIA</u>

Mr. Walter W. Meek argued on behalf of the AUIA that while Dr. Zepp, Arizona-American's witness, believes that a utility's authorized rate of return should reflect the comparable risk principle, Staff's witness, Mr. Reiker, prefers a textbook approach dependent on historical data. Mr. Meek observes that while Mr. Reiker distrusts forecasts and believes that investors will rely primarily on past performance for guidance, Dr. Zepp believes that the assumptions underlying an authorized return on equity should reflect the conditions that will prevail in the financial market at the time rates are in effect. Mr. Meek disagrees with Mr. Reiker's utilization of spot market rates as opposed to forecasted interest rates, and contends that Staff's conclusions, assumptions and decision points all lead to a lower rate of return for the Company than would Dr. Zepp's.

---

[9] *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).
[10] *Bluefield Waterworks & Improvement Co. v. Public Serv. Comm'n of W. Va.*, 262 U.S. 679 (1923).

e. Mr. Grimmelmann

Mr. Grimmelmann asserted that during a period of low inflation, the rate of return necessary to attract investors and needed capital is substantially lower than that requested by the Company in this proceeding, and supports the recommendations of Staff and/or RUCO.

2. Discussion

In regard to Arizona-American's arguments that Staff's cost of equity estimates are inconsistent with recent authorized returns on common equity, realized returns on common equity, *Value Line's* forecasted returns on common equity, and forecasted Treasuries rates, we agree with Staff and RUCO that while the comparable earnings method was once widely used to determine equity cost, it has been replaced by market based corporate finance models, including the DCF method and the CAPM. We further agree that because the DCF method and the CAPM estimate the cost of equity by quantifying the anticipated dividends and capital gains investors expect to earn by purchasing shares of stock with comparable risk, their results meet the *Hope* comparable risk standard.

Arizona-American also argued that Staff and RUCO's cost of capital recommendations fail to satisfy the capital attraction standard and fail to insure Arizona-American's financial integrity. In response to the Company's assertion that Staff's recommended rate of return results in pre-tax interest coverage of approximately 1.0 in contrast to Staff's coverage ratio of 3.0, Staff responded that the Company's interest coverage calculation is improper, in that it uses accounting data including assets not devoted to public service, and that for ratemaking purposes, the Company is entitled to earn a return on assets that are devoted to public service. We agree. The Company's witness testified that the Company's debt service requirements include financing of the acquisition adjustment (Tr. at 390). The use of coverage ratios to affect calculation of capital costs and resulting rates of return is inappropriate and would once again indirectly include the amount of the acquisition adjustment, as we pointed out in our fair value rate base discussion above.

With respect to the competing "risk premium" analyses, we believe Staff's CAPM model properly takes into account risk for purposes of estimating equity costs. According to Staff, the accuracy of the Company's risk premium analysis is suspect due to its use of interest rate projections

(Exh. S-46 at 16-17). Mr. Reiker stated that Arizona-American's reliance on forecasted Baa bond rates is less reliable than Staff's methodology because bond forecasts have been historically inaccurate (*Id.* at 17). He also explained that corporate bonds contain default risk, which is unsystematic risk, and that investors do not expect a return which compensates for the acceptance of unsystematic risk (*Id.* at 17-19). We agree with Staff that assessing the risk premium based on corporate bond yields is inappropriate and believe that Staff's CAPM analysis, which includes a risk variable, is a reasonable means of estimating Arizona-American's cost of equity in this case and is preferable to the Company's proposed risk premium recommendation.

When Arizona-American restated Staff's witness Reiker's constant-growth DCF model, it did not include past dividends per share growth and near term dividends per share growth in its average growth rates (Exh. A-49 at 44–47). Arizona-American argued that when investors expect earnings per share to grow more rapidly than dividends per share, the earnings retention ratio will increase and investors will expect faster future growth (*Id.*). As Staff points out, however, investors are just as likely to conclude that a company lacks confidence that earnings growth can be sustained, expects future earnings to decrease, and wants to avoid future dividend cutting when earnings decline (Exh. S-46 at 12). We agree with Staff that dividend growth should be included in the DCF model because the DCF formula is predicated on dividend growth, and that the omission of dividend per share growth from the DCF model moves the model's result away from and not toward a reliable estimation, which works only to inflate the estimate to the detriment of ratepayers. Arizona-American also restated Staff's multi-stage DCF analysis by inserting a new second stage between Staff's first and second stages that includes both the *Value Line* forecasts of dividend per share growth and subsequent forecasts of intrinsic growth (Exh. S-49 at 48). While Dr. Zepp presented an e-mail from Myron Gordon in support of the inclusion of this second stage, the e-mail states that Dr. Gordon cannot comment on "whether Dr. Zepp used the best possible method" to implement the principle espoused in the e-mail, which concerned a gas LDC case (Exh. A-50, Ex. TMZ-RJ-2). Staff believes that Dr. Zepp's inputs for this additional growth stage illogically assume that investors would use *Value Line's* projected retention growth rate instead of using the dividend per share growth rate projected by *Value Line* for the years 2007 and 2008. As Staff points out, Dr. Zepp's multi-stage

DCF restatement also speculatively applies *Value Line's* projected retention growth rate for 2006 through 2008 to the years 2009 through 2016 (Exh. A-49, Tables 8, 9). We find that the methodology and variables used by Staff provide a reliable and reasonable determination of dividend yield growth in both its constant and non-constant growth models.

3. Conclusion

Staff has performed a rigorous cost of equity analysis in this case that withstands the Company's and AUIA's critiques. Staff's analysis is based on sound economic principles, and represents a fair and reasonable estimate of Arizona-American's cost of equity for purposes of this proceeding. As described above, Staff arrived at a 9.0 percent cost of equity estimate through application of both the constant growth and multi-stage DCF models and the CAPM.

C. <u>Cost of Capital Summary</u>

	Percentage	Cost	Weighted Cost
Long-Term Debt	60.1%	4.8%	2.9%
Common Equity	39.9%	9.0%	3.6%
Cost of Capital			6.5%

VIII. <u>RATE OF RETURN</u>

The Company proposed applying its recommended cost of capital directly to its estimated RCND, and objects to what it says is Staff's regular practice of calculating the revenue requirement by applying the weighted cost of capital to an OCRB, and then adjusting the rate of return on FVRB to produce the same revenue requirement (Co. Br. at 13-14). The Company contends that Staff "backed into" its calculation of a different allowable rate of return depending on the value of the rate base, so that the revenue requirement remains the same whichever rate base is used, and claims that this is improper under *Simms*, 80 Ariz. at 155, 294 P.2d at 385 (*Id.* at 15-16). In response to RUCO's contention that applying the weighted cost of capital solely to RCND factors inflation in twice, thereby overstating the revenue requirement, the Company argues that the *Bluefield* court's discussion of rates of return did not suggest that applying the rate of return double-counts inflation or that some sort of inflation-related adjustment was required (Co. Reply Br. at 15-16, citing *Bluefield Waterworks & Improvement Co. v. Public Serv. Comm'n of W. Va.*, 262 U.S. 679, 693-695 (1923)).

Arizona-American asserts that under RUCO's argument, changes in value would be irrelevant to the rate setting process because the revenue requirement is always based on OCRB (*Id.*).

The Company argues that the determination of rate base and of the rate of return to be applied to rate base are separate and independent determinations (*Id.* at 17-18). Staff disagrees with this contention (Exh. A-44 at 9-10; Tr. at 309, 311, 316). Staff states that "the rate of return can be calculated only after a fair value rate base has been determined," citing *City of Tucson v. Citizens Utils. Water Co.*, 17 Ariz. App. 477, 482, 489 P.2d 551, 556 (1972), and that the Commission must first determine fair value to use as the utility's rate base, and "then must" determine the rate of return, citing *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 534, 578 P.2d 612, 615 (App. 1978)(citing *Arizona Corp. Comm'n v. Arizona Pub. Serv. Co.*, 113 Ariz. 368, 370, 555P.2d 326, 328 (1976))(Staff Reply Br. at 7). Staff explained that it determines the fair value rate of return by multiplying the weighted average cost of capital by the OCRB, and then dividing the product by the FVRB (Staff Br. at 4). Staff states that under this approach, the fair value rate of return cannot be calculated before the FVRB, which satisfies the *City of Tucson* requirement. Staff contends that this is the approach the Commission has traditionally used, and is exactly the same approach the court discussed with approval in *Litchfield Park Serv. Co. v. Arizona Corp. Comm'n*, 178 Ariz. 431, 435, 874 P.2d 988, 992 (App. 1994) (Staff Br. at 5). In regard to the Company's assertion that Staff's approach creates a rate of return that varies by rate base, Staff responded that logically, Arizona-American's approach would also lead to a different return on OCRB than on RCND (Staff Reply Br. at 7). Finally, Staff points to the Arizona Supreme Court's affirmation of Commission Decision No. 43727 (October 22, 1973), which stated that cost of capital estimates must be restated if they are to be applied to a fair value rate base rather than an original cost rate base (Staff Reply Br. at 8, citing *Sun City Water Co. v. Arizona Corp. Comm'n*, 113 Ariz. 464, 465, 556 P.2d 1126, 1127 (1976)).

The rate of return methodology and resulting revenue increase proposed by Arizona-American would produce an excessive return on FVRB. There has been no legitimate basis presented for departing from the traditional ratemaking methodology of applying a fair value rate of return to the Company's FVRB in this proceeding. We find that applying a fair value rate of return to the FVRB is just, reasonable, and in accord with the mandates of the Arizona Constitution, and will adopt it in this case.

IX. AUTHORIZED INCREASE/DECREASE

With the adjustments adopted herein, the combined overall revenue effect for the ten Districts is to increase the Company's operating revenues by $1,340,249, or 3.79 percent.

For the Sun City West Water District, with the adjustments adopted herein, the adjusted test year operating income is $441,523. Further, the 6.5 percent cost of capital translates into a 5.70 percent fair value rate of return on FVRB of $13,643,019 as authorized hereinabove. Multiplying the 5.70 percent rate of return by the FVRB produces required operating income of $777,652. This is $336,129 more than the Company's test year adjusted operating income. Multiplying the deficiency by the gross revenue conversion factor of 1.62863 results in an increase in revenues of $547,430 or a 16.19 percent net increase over test year adjusted revenues.

For the Sun City West Wastewater District, with the adjustments adopted herein, the adjusted test year operating income is $5,482. Further, the 6.5 percent cost of capital translates into a 5.48 percent fair value rate of return on FVRB of $10,569,243 as authorized hereinabove. Multiplying the 5.48 percent rate of return by the FVRB produces required operating income of $579,195. This is $573,713 more than the Company's test year adjusted operating income. Multiplying the deficiency by the gross revenue conversion factor of 1.62863 results in an increase in revenues of $934,366 or a 26.43 percent net increase over test year adjusted revenues.

For the Sun City Water District, with the adjustments adopted herein, the adjusted test year operating income is $514,970. Further, the 6.5 percent cost of capital translates into a 4.32 percent fair value rate of return on FVRB of $32,904,707 as authorized hereinabove. Multiplying the 4.32 percent rate of return by the FVRB produces required operating income of $1,421,483. This is $906,513 more than the Company's test year adjusted operating income. Multiplying the deficiency by the gross revenue conversion factor of 1.62863 results in an increase in revenues of $1,476,373 or a 23.84 percent net increase over test year adjusted revenues.

For the Sun City Wastewater District, with the adjustments adopted herein, the adjusted test year operating income is $1,024,134. Further, the 6.5 percent cost of capital translates into a 4.37 percent fair value rate of return on FVRB of $12,956,687 as authorized hereinabove. Multiplying the

4.37 percent rate of return by the FVRB produces required operating income of $566,207. This is $457,927 less than the Company's test year adjusted operating income. Multiplying the excess by the gross revenue conversion factor of 1.62863 results in a decrease in revenues of $745,794 or a 14.66 percent net decrease from test year adjusted revenues.

For the Mohave Water District, with the adjustments adopted herein, the adjusted test year operating income is $986,128. Further, the 6.5 percent cost of capital translates into a 5.46 percent fair value rate of return on FVRB of $10,462,247 as authorized hereinabove. Multiplying the 5.46 percent rate of return by the FVRB produces required operating income of $571,239. This is $414,889 less than the Company's test year adjusted operating income. Multiplying the excess by the gross revenue conversion factor of 1.62863 results in a decrease in revenues of $675,701 or a 15.38 percent net decrease from test year adjusted revenues.

For the Havasu Water District, with the adjustments adopted herein, the adjusted test year operating income is $25,711. Further, the 6.5 percent cost of capital translates into a 5.44 percent fair value rate of return on FVRB of $982,391 as authorized hereinabove. Multiplying the 5.44 percent rate of return by the FVRB produces required operating income of $53,442. This is $27,731 more than the Company's test year adjusted operating income. Multiplying the deficiency by the gross revenue conversion factor of 1.62863 results in an increase in revenues of $45,163 or a 10.24 percent net increase over test year adjusted revenues.

For the Agua Fria Water District, with the adjustments adopted herein, the adjusted test year operating income is $1,248,941. Further, the 6.5 percent cost of capital translates into a 6.20 percent fair value rate of return on FVRB of $17,474,464 as authorized hereinabove. Multiplying the 6.20 percent rate of return by the FVRB produces required operating income of $1,083,417. This is $165,524 less than the Company's test year adjusted operating income. Multiplying the excess by the gross revenue conversion factor of 1.62863 results in a decrease in revenues of $269,577 or a 4.36 percent net decrease from test year adjusted revenues.

For the Anthem Water District, with the adjustments adopted herein, the adjusted test year operating income is $774,886. Further, the 6.5 percent cost of capital translates into a 6.38 percent fair value rate of return on FVRB of $9,449,190 as authorized hereinabove. Multiplying the 6.38

percent rate of return by the FVRB produces required operating income of $602,858. This is $172,028 less than the Company's test year adjusted operating income. Multiplying the excess by the gross revenue conversion factor of 1.62863 results in a decrease in revenues of $280,170 or a 6.99 percent net decrease from test year adjusted revenues.

For the Anthem/Agua Fria Wastewater District, with the adjustments adopted herein, the adjusted test year operating income is $38,323. Further, the 6.5 percent cost of capital translates into a 6.43 percent fair value rate of return on FVRB of $2,761,046 as authorized hereinabove. Multiplying the 6.43 percent rate of return by the FVRB produces required operating income of $177,535. This is $139,212 more than the Company's test year adjusted operating income. Multiplying the deficiency by the gross revenue conversion factor of 1.62863 results in an increase in revenues of $226,725 or a 12.15 percent net increase over test year adjusted revenues.

For the Tubac Water District, with the adjustments adopted herein, the adjusted test year operating income is $23,270. Further, the 6.5 percent cost of capital translates into a 5.12 percent fair value rate of return on FVRB of $1,431,070 as authorized hereinabove. Multiplying the 5.12 percent rate of return by the FVRB produces required operating income of $73,271. This is $50,001 more than the Company's test year adjusted operating income. Multiplying the deficiency by the gross revenue conversion factor of 1.62863 results in an increase in revenues of $81,434 or a 32.00 percent net increase over test year adjusted revenues.

X. RATE DESIGN

A. Initial Rate Design Filings

In its applications, Arizona-American proposed to maintain the same rate designs as those previously approved by the Commission when the water and wastewater districts were owned and operated by Citizens, and proposed that the necessary rate increases be allocated among all customers equally (Exh. A-52 at 34, Exh. A-62 at 23). RUCO also proposed a rate design that resembles the current rate design and maintains the same relationship between meter sizes, the same allocations between minimums and commodity rates, and the current tier structures (Exh. R-7 at 31). Staff initially recommended a three-tier inverted block rate structure with break-over points at 4,000 gallons and 100,000 gallons of use for each system across all meter sizes and all customer classes with the exclusion of customer/irrigation and fire protection customers (Exh. S-36 at 5). While the Company and RUCO continue to support their original rate design proposals (although the Company has offered an alternative proposal for review), Staff, as explained below, filed a revised version of its rate design with its closing brief.

B. Post-hearing Rate Design Filings

On February 4, 2004, Arizona-American filed alternative rate design schedules as an exhibit to its initial closing brief, and simultaneously filed a Motion to Supplement the Record to Include Illustrative Schedules on Inverted-Block Rate Design. Arizona-American stated that although it developed the alternative conservation-oriented schedules in response to Commissioner Mundell's comments to the Company on the first day of the hearing, the Company does not believe it is necessary or appropriate to implement a radical change in its rate design for its seven water districts in this case, as four of the water districts already have two-tier, inverted block rates; the Anthem Water District uses surface water from the Colorado River; and the remaining water districts, Mohave and Havasu, are outside an active management area. The Motion stated that the Company had provided the alternative schedules to the other parties on January 27, 2004.

Youngtown, Sun Health, and Mr. Grimmelmann did not directly respond to the Motion, but all acknowledged, without objection, Arizona-American's alternative schedules in their initial closing briefs.

RUCO's February 6, 2004, Response to the Motion stated that it generally opposes the admission of evidence after the close of the record because there is no opportunity for cross-examination and offering of rebuttal evidence, but it respected the Company's desire to offer an alternative rate design in response to the Commissioner's comments, and that given the timing of the comments, the late filing appeared appropriate. RUCO stated that it intended to respond to the supplemental rate design in its reply brief, and was therefore not requesting additional process.

Staff stated in its initial closing brief that it had no objection to the admission of the alternative schedules, but reserved the right to address them, and to provide its own updated rate design proposal, in its reply brief. Staff's February 9, 2004, Response to the Motion stated that it did not oppose the Motion as long as all other parties would have the opportunity to supplement the record with their responses to the schedules in their own briefs.

A Procedural Order was issued on February 11, 2004 granting the Motion and requiring parties wishing to respond to the Company's alternative rate design to do so in their reply briefs. Mr. Grimmelmann, Youngtown, Sun Health, and RUCO responded in their reply briefs. Staff also responded, and included its own revised rate design and schedules in its reply brief. Accordingly, the timeclock is extended.

1. Arizona-American's Alternative Inverted-Block Rate Design Proposal

Arizona-American's proposed alternative rate design is similar to Staff's initial inverted block rate structure, but has different rate structures for residential and non-residential customers. Monthly minimum charges are determined by meter size, based on 65% of the monthly minimum charges computed in the Company's rebuttal testimony cost of service studies (Exh. A-62), which used Staff's Plant and Expenses. The monthly minimums include no gallons of water except in the instance of the multi-family residential monthly charges for the Mohave and Havasu Water Districts, which continue to include 1,000 gallons in the monthly minimum per customer. For those Districts, the monthly minimum charge for multi-family residential customers (e.g., apartment complexes and mobile home parks) is based on the computed monthly minimum charge for a 5/8-inch meter multiplied by the number of units in the complex. For all remaining customer classes, the proposed alternative rate design includes a monthly minimum charge based on the size of the meter from which water is provided.

For residential customers, break-over points between the three tiers are set at approximately 33% and 67% of the consolidation factor, and each tier for each District has specific commodity rates. Break-over points for residential customers differ by District, based on test year water use characteristics, and do not vary by meter size. Non-residential general metered customers have a two-tier inverted block commodity rate, with break-over points that vary based on meter size, and by District, based on water use characteristics, with break-over points set at approximately 60% of the relevant consolidation factor for each meter size. The Company believes that this is more equitable than Staff's initial rate design, because it does not treat commercial customers on smaller (3/4 –inch and one-inch) meters the same as commercial customers on larger (4 and 6-inch) meters. For Sun

City and Mohave only, Arizona-American computed the break-over points for the customer class as a whole rather than by meter size. In addition, the break-over point for the irrigation customer class in Sun City was also computed as a class rather than by meter size.

2. Staff's Revised Inverted-Block Rate Design Proposal

Staff stated that it does not endorse Arizona-American's alternative rate design proposal. In response to that proposal, and in response to criticism of Staff's initial rate design, Staff attached a revised rate design proposal to its reply brief. Staff's revised rate design is based on meter size, not on the class of customer, and differentiates between meter sizes by increasing the break-over point between tiers as the meter size increases. The increasing break-over point applies to all classes of customers within the meter size, which Staff believes successfully responds to the concerns of Sun Health and Youngtown. The revised design will not allow customers to "cross-over," or circumvent water usage costs by moving to a larger meter. For the majority of meter sizes, Staff's revised design is a two-tier inverted block rate design. However, because of the nondiscretionary character of water use by residential customers, Staff added a first tier of 4,000 gallons for the smallest meter sizes for residential customers. Except for this "nondiscretionary" tier for residential customers, Staff's revised rate design charges commercial and residential customers exactly the same for their water use based on meter size.

Staff's revised rate design also addresses the pricing concerns of multi-family residential customers and multi-unit commercial customers for the Mohave and Havasu Water Districts. Staff's revised design for these customers calculates the monthly minimum charge by taking the monthly minimum for 5/8-inch meter customers, multiplying that by the number of units and dividing the product in half. Staff believes that its proposal begins the move toward a design that charges these multi-family residential and multi-unit commercial customers based on actual meter size while avoiding significant impact on other customers, but continues to recommend that this issue be fully addressed by Arizona-American in its next rate case.

3. Discussion

The Company responded to Staff's initial rate design, stating that it would not promote conservation. Arizona-American's witness Mr. Kozoman stated that selling water to all customers at a discounted rate below the cost of service does not encourage water use efficiency, and that in reality such a discount would encourage inefficient water use by sending the wrong price signal, particularly since the discounted commodity rate would be applicable to all customers (Exh. A-62 at 4-5). The Company's witness further argued that "lifeline" and other types of discounted rates are contrary to other basic cost of service principles in that they produce a subsidy that must be recovered by means of higher rates in other usage blocks. He therefore believes they should only be available to residential customers who meet income eligibility requirements (Exh. A-62 at 5, 6). Mr. Kozoman also stated that "lifeline" rates and similar types of discounted rates should not be used in areas where there are water shortages or where water use is a concern (*Id.*).

Youngtown did not present evidence on the cost of service or a new rate design, but advocated spreading the rate increase evenly across the existing rates, as proposed by the Company in its application. Youngtown's witness, Mr. Burton, testified that rate "re-design" should not accompany a significant increase in rates, and suggested that the Commission examine rate design separately after the Commission has set a revenue level (Tr. at 1298-1300). Mr. Burton opposed Staff's initial rate design as having too significant a break in the tiers and as not encouraging water conservation (Tr. at 1301-1302). Youngtown believes that customers will receive a clearer conservation price signal if the rates are re-designed after the rate increase goes into effect, instead of combining the rate re-design with the general rate increase. Youngtown stated that it had insufficient time to decide whether to budget the funds to analyze the alternative inverted-block rate design schedule the Company submitted in its closing brief in time to address it in its reply brief. Youngtown contends, however, that the impact on particular customers of different rate designs will differ significantly depending on the authorized revenue requirement, and argues that this justifies delaying action on altering the current rate design until a later date.

Sun Health responded to Staff's initial rate design by stating that while it supports the goal of conservation, and the encouragement of conservation through pricing structure, it would not promote water conservation and would unfairly penalize large commercial customers like Sun Health. Sun Health asserted that Staff's initial proposal would not encourage conservation because the break-over points are not based on usage, and fail to account for the difference in consumption between residential and commercial customers. Sun Health asserted that while the 100,000 gallon break-over point is too high to encourage residential customers to conserve, it is too low to encourage conservation among commercial customers, for whom it may not be possible to reduce consumption below 100,000 gallons. Sun Health requested that the Commission adopt a rate structure along the lines of the Company's alternative proposal, which includes separate break-over points for residential and commercial customers. Sun Health took no position on the revenue requirement aspects of the rate design proposal, only on the rate structure.

Mr. Grimmelmann stated that Staff's initial rate design did not appear to fairly distribute costs to customers or appropriately align economic incentives. He believes that a design based on water usage offers a more appropriate economic alignment than one based on meter size, and protests that Staff's initial proposal would inequitably impact residential customers required to use a larger meter size due to code requirements, such as sprinkler systems. Mr. Grimmelmann argued that the size of the meter is totally independent of the water usage of a home and conservation incentives. Regarding the Company's alternative rate design, he stated that he supports the adoption of a conservation structure for residential customers without consideration of meter size, and that the Company's proposal seems equitable, as long as it is revenue neutral for the Anthem Water District as a whole.

Following its review of the Company's alternative rate design, RUCO again recommended that the Commission adopt RUCO's proposed rate design, which is similar to the rate design currently in effect. RUCO stated, however, that should the Commission lean toward an inverted-tier rate structure, that the Company's alternative rate design presents a more reasonable and fair cost allocation amongst the tiers than Staff's initial rate design, and would better encourage conservation.

Staff states that while it appreciates Arizona-American's efforts in designing its alternative rate design proposal and while in many ways, the alternative proposal is an improvement, Staff still cannot support it, because it includes higher break-over points between tiers for commercial customers than for residential customers, so that residential customers would pay more than commercial customers for the same services, which Staff believes unfairly discriminates against residential customers. Staff contends that commercial customers do not have an inelastic need for water in the way that residential customers do, and that recognition of nondiscretionary use for commercial customers is therefore not justified. Staff is also critical of Arizona-American's alternative design for commercial customers because it is based on each meter size independently without considering consumption across meter sizes. Staff asserts that the Company's isolated calculation of break-over points between tiers leads to multiple "cross-over" situations, in which a customer's bill would be greater if the customer had a smaller versus a larger meter and used an equal amount of water. As an example, Staff points out that for Anthem District commercial customers, the Company's alternative rate design (with the Company's rates) for 3/4–inch and 1-inch meters would result in a 3/4-inch customer's bill being greater than a 1-inch customer's bill at all consumption levels exceeding 50,000 gallons. Staff is critical of Arizona-American's attempt to address the situation of the minimum charges for multi-family residential and multi-unit commercial customers for the Mohave and Havasu districts, because the Company's alternative rate design would still charge these customers a higher amount than all other customers with similar consumption and the same meter sizes. In addition, Staff states that the Company's proposed rate design for these classes of customers creates the need for 125 bill counts for the Mohave District alone, making the design unwieldy and difficult to regulate.

4. Conclusion

Of the rate designs presented, we find that overall, Staff's revised rate design most appropriately addresses the considerations raised by all the parties, and best addresses the goals of conservation, efficient water use, affordability, fairness, simplicity, and revenue stability. Therefore, we will adopt Staff's revised rate design.

We believe that Staff's revised rate design for multi-family residential customers and multi-unit commercial customers in the Mohave and Havasu Water Districts follows the concept of gradualism, addressing the pricing concerns in existence there while avoiding significant customer impact in this rate proceeding. We understand that Arizona-American inherited the existing pricing inconsistency issues for the multi-family residential customers and multi-unit commercial customers. We will require Arizona-American to include a proposal in its next rate case filing for the Mohave and Havasu Water Districts that will complete the move to a simpler, more conventional rate design whereby these customers will pay the minimum charge based upon actual meter size.

Arizona-American's wastewater rates consist of a flat monthly rate. In general, all customers in a class are charged the same amount regardless of how much that customer taxes the system. However, for Arizona-American's water rates, we adopt a tiered rate design that requires customers who use more water to pay more. We find that this encourages water conservation. Some municipal wastewater systems bill their customers based on the amount of water they use. To determine if tiered wastewater rates based on water consumption would be an appropriate rate design, we will require Arizona-American to include a proposal in its next rate case filing for the Sun City West, Sun City and Anthem/Agua Fria wastewater systems that will present information on 1) whether wastewater rates based on water consumption encourage water conservation; 2) whether higher bills for those who use the system more is a fairer way to collect revenue; and 3) what tiered wastewater rates based on water consumption would look like compared to a flat rate design.

C. Tolleson Agreement Cost Adjustor Mechanism

Arizona-American's Sun City Wastewater District does not own or operate a wastewater treatment plant, but transports wastewater flows from this system to the Tolleson Wastewater Treatment Plant located in and owned and operated by the City of Tolleson ("Tolleson"), which treats the flows pursuant to an agreement between Tolleson and Arizona-American's predecessor in interest, originally executed on June 21, 1985 ("Tolleson Agreement"). During the test year under the Tolleson Agreement, the Company made payments to Tolleson under Rate Components One, Two and Three. Rate Component One is a fixed annual user charge related to bond financing issued by Tolleson to pay for the original plant additions Tolleson made in order to receive and treat the Sun City District's wastewater flows. Rate Component Two is a monthly operating and maintenance ("O&M") charge based on the Company's proportionate share of actual O&M costs based on actual flows. During the test year, Rate Component Three consisted of a $1,500 monthly payment for replacement and contingency reserves up to an aggregate balance of $90,000 (Exh. A-37 at 6-7). Tolleson is currently undertaking a facility improvement plan for the Tolleson Wastewater Treatment Plant, and according to Arizona-American, anticipates spending $40 million on capital projects through 2008.

The Company and Tolleson executed the Third Amendment to the Tolleson Agreement on

April 22, 2003 (*See* Exh. S-1). The Third Amendment provides a mechanism for Arizona-American to pay Tolleson its proportionate share of the increased costs associated with necessary repairs and improvements to the facility by modifying the existing Rate Component Three and adding a new Rate Component Four. The Third Amendment increased Rate Component Three's payment for replacement and contingencies reserves from $1,500 to $20,000 per month, and increased the aggregate balance limit from $90,000 to $200,000. Under the new Rate Component Four, Arizona-American will pay its pro rata share of major capital improvement projects, which the Company estimates at roughly $10 million.

In Decision No. 66386 (October 6, 2003), we authorized Arizona-American to defer, for accounting purposes, the increased costs associated with the increase to the Third Rate Component and the new Fourth Rate Component as set forth in the Third Amendment.

Under Arizona-American's cost adjustor mechanism proposal, the Company would pass through an amortized portion of the actual payments made to Tolleson under Rate Components Three and Four, (the amortization period being equal to the remaining life of the Agreement), plus the annual carrying cost of any associated debt which would include interest expense less the income tax savings on the interest component (Exh. A-1 at 8-11). Arizona-American states that it has sought to minimize the impact of substantial but necessary expenses on its customers by means of the cost recovery mechanism, and that the mechanism would not be complex to customers because they would simply see a line item on their bill for the Tolleson costs. The Company contends that adjustor mechanisms are not improper; that the Company utilizes an adjustor mechanism in its Sun City Water District to allow for the recovery of CAP water costs; and that the Company's increased costs under the Third Amendment are not yet fixed in amount or date of payment, but are significant, variable and outside the Company's control. The Company argues in support of the adjustor that its input to Tolleson over improvement costs under the Third Amendment is not equivalent to control over the costs.

Arizona-American contends that the proposed adjustor would furnish it the certainty necessary to finance and pay substantial amounts to Tolleson in order to insure continued wastewater treatment. The Company argues that rejection of its proposed cost recovery mechanism would be unfair and threaten the Company's financial integrity, asserting that under Staff's and RUCO's recommended rate reduction for the Sun City Wastewater District, it would be unable to pay for the Tolleson costs through revenues from its wastewater customers, and this would likely diminish the amount of capital available for other capital improvement projects. Arizona-American asserts that these Tolleson costs should not be treated just like any other capital expenditure that Arizona-American would make to build plant, because the Tolleson costs are not plant investment, but costs incurred under a contract to obtain wastewater treatment services for the Company's ratepayers (Exh. A-43 at 13-14).

The Company argues that under the proposed adjustor mechanism, ratepayers would only pay for actual costs at the time that they are "known and measurable" (Tr. at 145-46). The Company states that since May 2003, it has been paying $20,000 per month under Rate Component Three (Exh. A-43 at 13); that this component of the Third Amendment is known and measurable; and that the Company fully anticipates incurring this maximum charge under Rate Component Three each month due to the substantial need for upgrades at the Tolleson Wastewater Treatment Plant. While the exact amount to be paid under Rate Component Four is not yet certain, the Company asserts that the obligation to pay an estimated $10 million to Tolleson is known.

SCTA states it is in agreement with Staff and the long-standing position of the Commission to allow recovery of costs only after completion of plant and/or improvements and the determination of a net benefit to consumers (SCTA Br. at 1).

RUCO recommends denial of the request because the additional costs associated with the Tolleson Wastewater Treatment Plant are not known and measurable at this time and because when the expenses do become known and measurable, the amounts will be set amounts that will not fluctuate widely (Exh. R-7 at 29). While not advocating that the Company be denied its costs, RUCO recommends that the costs continue to be deferred pursuant to Decision No. 66386, and that the Commission consider the costs when they are known and measurable.

Staff requests that the Commission reject the proposed adjustor because Arizona-American did not incur any Rate Component Four cost in the test year, and because Rate Component Three's contingency and reserve fund is reserved for unknown future plant additions and replacements. Staff believes there should be no recovery until plant additions are completed from this fund (Exh. S-48 at 10-11). Like RUCO, Staff argues that ratemaking theory allows for adjustors only in limited circumstances not present here (citing *Scates*, 118 Ariz. at 535, 578 P.2d at 616 (Adjustor may be used for "fluctuations in certain, narrowly defined, operating expenses")). Staff contends that the Third Amendment's contractual procedures allowing Arizona-American's input and review of the Tolleson costs give Arizona-American some control over the costs. Staff further asserts that the costs are simply unknown at this time; that the estimated cost for Rate Component Four has already increased by $2 million over the course of this proceeding (Tr. at 147-48); that the Third Amendment contains provisions to add new capital projects not included in the current estimates (Exh. S-1 at 3); that the complexity of the adjustor mechanism does not meet the important goal of simplicity in rate design; and that the Commission previously decided to discontinue an adjustor for Tolleson costs in a prior rate case (*See* Decision No. 60172, Exh. S-2 at 33).

Staff contends that requiring capital investment to fund a capital project does not destroy financial integrity, and further, that the Company's claim is based on treating the Sun City District as a stand-alone entity. Staff contends that such an argument is contrary to the benefit touted by the Company of the increased access to capital that would follow approval of the RWE transaction, and that Arizona-American should not now be able to deny the existence of that benefit.

When Decision No. 66386 was issued, Arizona-American's request for the adjustor mechanism was pending. Our Decision recognized that the issuance of the accounting order did not assure recovery of the costs in rates, but that without such an accounting order, the Company would be foreclosed from possible future recovery of such costs as a regulatory asset. We therefore ordered the Company to prepare and retain accounting records sufficient to permit a detailed review, in a rate proceeding, of all recorded deferred costs.

We agree with RUCO and Staff that the additional costs associated with the Third Amendment are not sufficiently known and measurable at this time to allow them to simply be passed through to customers without thorough review, and will therefore not approve the proposed adjustor mechanism. The Company testified that it plans to file another rate case within the next three years (Tr. at 365). We find it reasonable to wait to examine this issue until that time, when the recorded deferred costs should be sufficiently known and measurable to allow for a full examination.

D. Sun City Irrigation Tariff

Youngtown requests that the Sun City Water District's Irrigation Water Rate Tariff be expanded to be available to it for water deliveries to Maricopa Lake, a 2.8 surface acre lake in existence since 1955, which is owned and operated by Youngtown as a recreational facility (Exh. Y-5 at 13-14). The Sun City Water District's approved irrigation water rate tariff is currently available only to the Sun City Agricultural Club, golf courses and irrigated medians south of Grand Avenue. It has a higher monthly charge but significantly lower gallonage rate than non-irrigation rates, and is interruptible. Youngtown contends that the limited access to the present tariff is discriminatory.

The first sentence of the Sun City Water District's Irrigation Water Rate tariff currently reads as follows:

> Availability
>
> Available only to the Sun City Agricultural Club, golf courses and irrigated medians, south of Grand Avenue.

Youngtown proposes that the Sun City Water District's Irrigation Water Rate tariff be amended to read as follows:

> Availability
>
> Available only to: 1) the Sun City Agricultural Club; 2) golf courses; 3) irrigated medians south of Grand Avenue; and 4) irrigated medians, lakes and golf courses owned by political subdivisions of the State of Arizona and served by Arizona-American Sun City Water District as of the effective date of this Tariff.

Arizona-American states that it does not object to Youngtown's proposal, but that because the tariffed irrigation rate is lower than the general rate for non-residential customers, the tariff change would result in a reduction in revenue, requiring other customers to make up for the revenue shortfall (Exh. A-62 at 35).

In support of its request, Youngtown asserts that Maricopa Lake is an amenity available to all residential customers; that it has not been demonstrated that its use of the tariff would cause an appreciable shift in revenues or that additional revenues would fall predominantly on the residential class; and that the revenue shortfall would be made up by larger water users. We agree with

Youngtown that it is reasonable to allow it access to the irrigation tariff for water deliveries to Maricopa Lake, which is open to the public and may be enjoyed by all Sun City water customers. Youngtown's proposed language change will allow it the choice of either continuing on the commercial rate under the new rate design adopted herein, or electing the irrigation rate. We will require that the Company file an updated Irrigation Tariff with Youngtown's proposed language.

E. Water System Service Line and Meter Installation/Wastewater Service Charges

Staff's testimony recommends that the Company's proposed water system service line and meter installation charges and wastewater system service charges be accepted (Exh. A-26 at 9, 13). Additionally, the Company proposes to collect the income taxes associated with its collection of service line and meter installation charges because these charges, although treated as refundable advances for regulatory purposes, have been interpreted by the Internal Revenue Service to constitute taxable income (Exh. A-52 at 10). These proposals are all reasonable and will be approved.

F. Phase-in/Stepped Rate Increase

The Company proposed that to the extent the rate increase for any District is over 40 percent, that the increase be phased in, in two steps. The first step would be a 40 percent increase, with the balance picked up a year later. Youngtown suggested an alternative phasing of two equal steps if the approved increase is between 20 percent and 40 percent, and three equal steps if the increase is greater than 40 percent, with the same phasing for the rate decrease it anticipated for the Sun City Sewer District (Tr. at 1243, 1244). Youngtown asserts that a phased-in rate merely recognizes that the return allowed by the initial step increase is all that is fair and reasonable to the customer, unless the adverse impacts of a greater return are ameliorated by stepping in the increase. Youngtown states that the alternative to a phase-in approach is to approve only the first step and require the Company to refile, which would increase regulatory costs. Youngtown contends that *Arizona Community Action Ass'n v. Arizona Corp. Comm'n,* 123 Ariz. 228, 599 P.2d 184 (*"ACAA"*), expressly recognizes that stepped rates may be approved by the Commission.

Arizona-American opposes Youngtown's proposal, stating that it would deprive the Company of a fair return on its rate base. The Company believes that *ACAA* is distinguishable from the facts here, stating that the *ACAA* court found it reasonable for the Commission to authorize future stepped rate increases based on construction work in progress ("CWIP"), and not to withhold authorized rate increases (Co. Reply Br. at 45).

The revenue levels approved herein include an increase of 23.84 percent for the Sun City Water District and a decrease of 14.66 percent for the Sun City Sewer District. The net effect of the new revenue levels affecting the Company's water and wastewater customers in the town of Youngtown, taken together, does not reach 20 percent, the rate increase level at which Youngtown proposed a phase-in, so we find it unnecessary to consider Youngtown's request in this proceeding.

G. <u>Low Income Program for Sun City and Sun City West Districts</u>

Decision No. 65655 (February 20, 2003) ordered the Company to submit for approval a Low Income Program for the Sun City and Sun City West Water Districts, and the Company now requests approval of its proposal for the program (Exh. A-62 at 2). Staff explained that under the Company's proposal, the surcharge approved in Decision No. 65655 associated with the use of Central Arizona Project ("CAP") water in those Districts would not be charged to residential customers on 5/8-inch and ¾-inch meters with incomes below 150 percent of federal poverty guidelines, who file with the Arizona Department of Economic Security. The surcharge revenues credited to those qualifying customers would be added to the Company's Groundwater Savings Program balance, and collected from the remaining customers paying the surcharge (Exh. S-36 at 4). We find the Company's proposal and Staff's recommendation reasonable, and will approve the program.

. . .

. . .

XI. OTHER ISSUES

A. Depreciation Rates

Staff recommends in its testimony that the Company continue to use its current depreciation rates. The Company did not object. This recommendation is reasonable and we will adopt it.

B. Water Loss Reports and Plans

Staff notes in its testimony that the Havasu, Lake Mohave Highlands, Desert Foothills, and Mohave-Main water systems show non-account water losses of greater than 10 percent. Staff recommends that effective upon the date of this Decision, the Company be required to monitor these over-limit systems and submit reports to the Director of the Utilities Division within 30 days after the end of each six-month period for one year, indicating the quantity of water pumped, gallons sold and water loss percentage for each month during that six-month period. Staff recommends that if water loss cannot be reduced to less than 10 percent, the Company be required to submit to the Director of the Utilities Division, within 18 months of this Decision, a plan that outlines the procedures, steps and timeframes to achieve acceptable levels of water loss. The Company did not object to this Staff recommendation. It is reasonable and we will adopt it.

C. Curtailment Plan Tariffs

Staff's testimony recommends that the Company be required to submit, within 90 days of this Decision, Curtailment Plan Tariffs conforming to the sample tariff posted on the Commission's website to the Director of the Utilities Division for review and certification for all the systems in its Mohave Water District, and for its Tubac, Havasu, Sun City, Sun City West, Agua Fria, and Anthem Water Districts. This recommendation is reasonable and will be adopted.

* * * * * * * * * *

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

FINDINGS OF FACT

1. Arizona-American is an Arizona corporation engaged in the business of providing water and wastewater utility service to customers in its various water and wastewater districts located in portions of Maricopa, Mohave and Santa Cruz counties in Arizona pursuant to authority granted by the Commission. Arizona-American currently provides service to approximately 115,000 customers.

2. Arizona-American is a wholly-owned subsidiary of American Water Works, Inc. The ultimate parent of American Water Works, Inc. is RWE AG.

3. The Commission approved the sale of Citizens' water and wastewater utility plant, property and assets in Arizona, and the transfer of Citizens' related Certificates of Convenience and Necessity to Arizona-American in Decision No. 63584 (April 24, 2001). The Commission approved debt financing for Arizona-American's acquisition in Decision No. 64002 (August 30, 2001).

4. On December 12, 2002, the Commission issued Decision No. 65453, which conditionally approved, under the Commission's Public Utility Holding Companies and Affiliated Interests Rules, A.A.C. R14-2-801 *et seq.*, a reorganization consisting of the merger of Arizona-American's parent, American Water Works Company, Inc., with a subsidiary of RWE AG. One condition of the Commission's approval was that Arizona-American refrain from filing any non-emergency rate increase requests for three years from the closing date of the reorganization. The consolidated rate applications were filed prior to the closing date of the reorganization, and thus are not subject to the conditions of Decision No. 65453. Arizona-American's appeal of Decision No. 65453 is pending in the Arizona Court of Appeals.

5. On November 22, and December 13, 2002, Arizona-American filed with the Commission the above-captioned applications for rate adjustments in ten of its water and wastewater Districts.

6. On January 30, 2003, Staff filed a letter stating that the applications met the sufficiency requirements set forth in A.A.C. R14-2-103.

7. A Procedural Order was issued March 14, 2003, consolidating the applications and setting a hearing for October 14, 2003.

8. An Amended Rate Case Procedural Order was issued on June 6, 2003, granting a

request by Arizona-American and Staff to continue the hearing, and setting a new hearing date of December 4, 2003.

9. Intervention was granted to RUCO, Mr. Carlton G. Young, Mr. Frank J. Grimmelmann, SCTA, Youngtown, AUIA, Fiesta, and Sun Health.

10. A pre-hearing conference was conducted on December 1, 2003. Public comment hearings were conducted in Anthem on November 5, in Surprise and Sun City on November 12, in Bullhead City and Lake Havasu City on November 13, and in Tubac on November 18, 2003. The evidentiary hearing commenced on December 4, 2003, and concluded on December 23, 2003.

11. Closing briefs were filed on February 4, 2004 and reply briefs were filed on February 18, 2004.

12. On March 3, 2004, a letter from Commissioner Mundell to the Director of the Commission's Utilities Division Staff was filed in these dockets. The letter requested a response from Staff regarding the issue of high nitrate levels in Desert Hills, a water system in the Havasu Water District.

13. On March 8, 2004, Staff filed the requested response, indicating that the latest Arizona Department of Environmental Quality ("ADEQ") report available when Staff filed its testimony in this matter stated that the Desert Hills system was delivering water that met all required water quality standards, but that a public health risk currently existed for infants aged 6 months or less due to the elevated nitrate levels; that the Company had notified its customers of the risk and was providing bottled water to the at-risk group or any concerned customers in the system; that the Company was in the process of obtaining a new source of water to blend with the existing source in order to deliver water meeting acceptable nitrate level requirements; and that the Company was complying with the requirements of ADEQ regarding this non-compliance issue.

14. On March 10, 2004, Arizona-American filed a notice of filing a copy of a letter to Commissioner Mundell regarding the Desert Hills ADEQ compliance issue. A copy of the letter was attached. The letter indicated that the Desert Hills system serves 1,250 households with three wells; that the system has consistently met all regulatory requirements for many years; that on February 13, 2004 regular water quality tests showed that nitrate levels in a portion of the Desert Hills system were

12 milligrams per liter ("mg/l"), exceeding the maximum contaminant level ("MCL") of 10 mg/l; and that previous measurement of nitrate levels ranged from 6 mg/l to 8 mg/l. The letter explained that because the Company received the 12 mg/l test results on a Friday preceding a holiday weekend, it was concerned about providing adequate notice to consumers and therefore utilized paid radio advertising from February 14 through February 16, 2004 to warn consumers of the health risks to infants. The letter stated that the Company also provided a bill insert for affected customers and issued a press release, and maintained contact with Staff to keep them apprised of progress in public notification. The letter also outlined the Company's plan to add a new supply source to the Desert Hills system to bring the system into compliance, and stated that the Company expected the project to be fully operational no later than the end of April, 2004.

15. On March 25, 2004, the Company filed a notice of filing a copy of a second letter to Commissioner Mundell regarding the Desert Hills compliance issue. The letter stated that mid-March samples determined that nitrate levels in the Desert Hills system had decreased to 8.3 mg/l, and that the reduced nitrate level had been confirmed by nine samples on three separate sampling events. The letter asserted that the Company was again in full compliance with water quality regulations in all of its systems throughout the State of Arizona.

16. Arizona-American's Mohave Water District is currently charging rates approved by Decision No. 56806 (February 1, 1990).

17. Arizona-American's Havasu Water District is currently charging rates approved by Decision No. 57743 (February 21, 1992).

18. Arizona-American's Sun City West Water and Wastewater Districts, Sun City Water and Wastewater Districts, Agua Fria Water District, and Tubac Water District are currently charging rates approved by Decision No. 60172 (May 7, 1997).

19. Arizona-American's Anthem Water District and Anthem/Agua Fria Wastewater District are currently charging rates approved by Decision No. 60975 (June 19, 1998).

20. Adoption of Arizona-American's proposed estimated reconstruction cost new less depreciation rate base as the sole basis for fair value rate base in this proceeding would be unreasonable and against the public interest. Further, the Company's proposal would allow it to

indirectly recover an acquisition adjustment for its purchase of the Citizens assets without complying with the requirements of Decision No. 63584.

21. It is premature to consider Arizona-American's request to deviate from the standard accounting amortization method for the acquisition adjustment it has recorded to show the accounting effect of its purchase of the Citizens assets.

22. For ratemaking purposes, the **Sun City West Water District**'s OCRB, RCND, and FVRB for the test year ended December 31, 2001 are determined to be $11,971,281, $15,314,756, and $13,643,019, respectively.

23. For the Sun City West Water District, with the adjustments adopted herein, the adjusted test year operating income is $441,523. Further, the 6.5 percent cost of capital translates into a 5.70 percent fair value rate of return on FVRB of $13,643,019 as authorized hereinabove. Multiplying the 5.70 percent rate of return by the FVRB produces required operating income of $777,652. This is $336,129 more than the Company's test year adjusted operating income. Multiplying the deficiency by the gross revenue conversion factor of 1.62863 results in an increase in revenues of $547,430 or a 16.19 percent net increase over test year adjusted revenues.

24. For the Sun City West Water District, the rates set herein result in a monthly increase of $1.67, or 14.35 percent for the average usage 5/8 x 3/4 inch meter customer (7,171 gallons/month) and a monthly increase of $1.26 or 11.91 percent, for the median usage 5/8 x 3/4 inch meter customer (6,000 gallons/month).

25. For ratemaking purposes, the **Sun City West Wastewater District**'s OCRB, RCND, and FVRB for the test year ended December 31, 2001 are determined to be $8,916,017, $12,222,469, and $10,569,243, respectively.

26. For the Sun City West Wastewater District, with the adjustments adopted herein, the adjusted test year operating income is $5,482. Further, the 6.5 percent cost of capital translates into a 5.48 percent fair value rate of return on FVRB of $10,569,243 as authorized hereinabove. Multiplying the 5.48 percent rate of return by the FVRB produces required operating income of $579,195. This is $573,713 more than the Company's test year adjusted operating income. Multiplying the deficiency by the gross revenue conversion factor of 1.62863 results in an increase in

revenues of $934,366 or a 26.43 percent net increase over test year adjusted revenues.

27. For the Sun City West Wastewater District, the rates set herein result in a monthly increase of $4.32, or 26.60 percent, for residential customers.

28. For ratemaking purposes, the **Sun City Water District**'s OCRB, RCND, and FVRB for the test year ended December 31, 2001 are determined to be $21,853,479, $43,955,934, and $32,904,707, respectively.

29. For the Sun City Water District, with the adjustments adopted herein, the adjusted test year operating income is $514,970. Further, the 6.5 percent cost of capital translates into a 4.32 percent fair value rate of return on FVRB of $32,904,707 as authorized hereinabove. Multiplying the 4.32 percent rate of return by the FVRB produces required operating income of $1,421,483. This is $906,513 more than the Company's test year adjusted operating income. Multiplying the deficiency by the gross revenue conversion factor of 1.62863 results in an increase in revenues of $1,476,373 or a 23.84 percent net increase over test year adjusted revenues.

30. For the Sun City Water District, the rates set herein result in a monthly increase of $2.84, or 25.40 percent for the average usage 5/8 x 3/4 inch customer (8,361 gallons/month) and a monthly increase of $2.40, or 23.74 percent, for the median usage 5/8 x 3/4 inch meter customer (7,000 gallons/months).

31. For ratemaking purposes, the **Sun City Wastewater District**'s OCRB, RCND, and FVRB for the test year ended December 31, 2001 are determined to be $8,713,382, $17,199,992, and $12,956,687, respectively.

32. For the Sun City Wastewater District, with the adjustments adopted herein, the adjusted test year operating income is $1,024,134. Further, the 6.5 percent cost of capital translates into a 4.37 percent fair value rate of return on FVRB of $12,956,687 as authorized hereinabove. Multiplying the 4.37 percent rate of return by the FVRB produces required operating income of $566,207. This is $457,927 less than the Company's test year adjusted operating income. Multiplying the excess by the gross revenue conversion factor of 1.62863 results in a decrease in revenues of $745,794 or a 14.66 percent net decrease from test year adjusted revenues.

33. For the Sun City Wastewater District, the rates set herein result in a monthly decrease

of $1.89, or 14.69 percent, for residential customers.

34. For ratemaking purposes, the **Mohave Water District**'s OCRB, RCND, and FVRB for the test year ended December 31, 2001 are determined to be $8,791,741, $12,132,752, and $10,462,247, respectively.

35. For the Mohave Water District, with the adjustments adopted herein, the adjusted test year operating income is $986,128. Further, the 6.5 percent cost of capital translates into a 5.46 percent fair value rate of return on FVRB of $10,462,247 as authorized hereinabove. Multiplying the 5.46 percent rate of return by the FVRB produces required operating income of $571,239. This is $414,889 less than the Company's test year adjusted operating income. Multiplying the excess by the gross revenue conversion factor of 1.62863 results in a decrease in revenues of $675,701 or an 15.38 percent net decrease from test year adjusted revenues.

36. For the Mohave Water District, the rates set herein result in a monthly decrease of $3.48, or 17.26 percent, for the average usage 5/8 x 3/4 inch meter customer (8,787 gallons/month) and a monthly decrease of $2.96, or 16.89 percent, for the median usage 5/8 x 3/4 inch meter customer (7,000 gallons/month).

37. For ratemaking purposes, the **Havasu Water District**'s OCRB, RCND, and FVRB for the test year ended December 31, 2001 are determined to be $822,117, $1,142,665, and $982,391, respectively.

38. For the Havasu Water District, with the adjustments adopted herein, the adjusted test year operating income is $25,711. Further, the 6.5 percent cost of capital translates into a 5.44 percent fair value rate of return on FVRB of $982,391 as authorized hereinabove. Multiplying the 5.44 percent rate of return by the FVRB produces required operating income of $53,442. This is $27,731 more than the Company's test year adjusted operating income. Multiplying the deficiency by the gross revenue conversion factor of 1.62863 results in an increase in revenues of $45,163 or a 10.24 percent net increase over test year adjusted revenues.

39. For the Havasu Water District, the rates set herein result in a monthly increase of $2.21, or 11.36 percent for the average usage 5/8 x 3/4 inch meter customer (7,659 gallons/month) and a monthly increase of $1.86, or 11.83 percent, for the median usage 5/8 x 3/4 inch meter

customer (5,000 gallons/month).

40. For ratemaking purposes, the **Agua Fria Water District**'s OCRB, RCND, and FVRB for the test year ended December 31, 2001 are determined to be $16,665,182, $18,283,746, and $17,474,464, respectively.

41. For the Agua Fria Water District, with the adjustments adopted herein, the adjusted test year operating income is $1,248,941. Further, the 6.5 percent cost of capital translates into a 6.20 percent fair value rate of return on FVRB of $17,474,464 as authorized hereinabove. Multiplying the 6.20 percent rate of return by the FVRB produces required operating income of $1,083,417. This is $165,524 less than the Company's test year adjusted operating income. Multiplying the excess by the gross revenue conversion factor of 1.62863 results in a decrease in revenues of $269,577 or a 4.36 percent net decrease from test year adjusted revenues.

42. For the Agua Fria Water District, the rates set herein result in a monthly decrease of $1.68, or 7.46 percent, for the average usage 5/8 x 3/4 inch meter customer (7,002 gallons/month) and a monthly decrease of $2.24, or 11.85 percent for the median usage 5/8 x 3/4 inch meter customer (5,000 gallons/month).

43. For ratemaking purposes, the **Anthem Water District**'s OCRB, RCND, and FVRB for the test year ended December 31, 2001 are determined to be $9,269,095, $9,629,285, and $9,449,190, respectively.

44. For the Anthem Water District, with the adjustments adopted herein, the adjusted test year operating income is $774,886. Further, the 6.5 percent cost of capital translates into a 6.38 percent fair value rate of return on FVRB of $9,449,190 as authorized hereinabove. Multiplying the 6.38 percent rate of return by the FVRB produces required operating income of $602,858. This is $172,028 less than the Company's test year adjusted operating income. Multiplying the excess by the gross revenue conversion factor of 1.62863 results in a decrease in revenues of $280,170 or a 6.99 percent net decrease from test year adjusted revenues.

45. For the Anthem Water District, the rates set herein result in a monthly decrease of $6.34, or 17.41 percent, for the average usage 5/8 x 3/4 inch meter customer (10,212 gallons/month) and a monthly decrease of $5.38, or 17.93 percent, for the median usage 5/8 x 3/4 inch meter

customer (7,000 gallons/month).

46. For ratemaking purposes, the **Anthem/Agua Fria Wastewater District**'s OCRB, RCND, and FVRB for the test year ended December 31, 2001 are determined to be $2,731,868, $2,790,224, and $2,761,046, respectively.

47. For the Anthem/Agua Fria Wastewater District, with the adjustments adopted herein, the adjusted test year operating income is $38,323. Further, the 6.5 percent cost of capital translates into a 6.43 percent fair value rate of return on FVRB of $2,761,046 as authorized hereinabove. Multiplying the 6.43 percent rate of return by the FVRB produces required operating income of $177,535. This is $139,212 more than the Company's test year adjusted operating income. Multiplying the deficiency by the gross revenue conversion factor of 1.62863 results in an increase in revenues of $226,725 or a 12.15 percent net increase over test year adjusted revenues.

48. For the Anthem/Agua Fria Wastewater District, the rates set herein result in a monthly increase of $8.11, or 27.05 percent, for residential customers.

49. For ratemaking purposes, the **Tubac Water District**'s OCRB, RCND, and FVRB for the test year ended December 31, 2001 are determined to be $1,127,661, $1,734,478, and $1,431,070, respectively.

50. For the Tubac Water District, with the adjustments adopted herein, the adjusted test year operating income is $23,270. Further, the 6.5 percent cost of capital translates into a 5.12 percent fair value rate of return on FVRB of $1,431,070 as authorized hereinabove. Multiplying the 5.12 percent rate of return by the FVRB produces required operating income of $73,271. This is $50,001 more than the Company's test year adjusted operating income. Multiplying the deficiency by the gross revenue conversion factor of 1.62863 results in an increase in revenues of $81,434 or a 32.00 percent net increase over test year adjusted revenues.

51. For the Tubac Water District, the rates set herein result in a monthly increase of $14.20, or 36.25 percent for the average usage 5/8 x 3/4 inch meter customer (13,177 gallons) and a monthly increase of $10.01, or 34.96 percent, for the median usage 5/8 x 3/4 inch meter customer (8,000 gallons).

52. The rate of return methodology and resulting revenue increases proposed by Arizona-

American would produce an excessive return on fair value rate base for each District.

53. The rate design adopted herein will promote conservation and send appropriate price signals to all customers. It is reasonable to require Arizona-American to include a proposal in its next rate case filing for the Mohave and Havasu Water Districts that will complete the move to a simpler, more conventional rate design for the multi-family residential customers and multi-unit commercial customers in those Districts, under which they will pay the minimum charge based upon actual meter size.

54. As discussed herein, Arizona-American's proposed Tolleson Agreement Cost Adjustor Mechanism should not be approved at this time.

55. The Sun City District's Irrigation Tariff should be modified as discussed herein.

56. Arizona-American's proposed Low Income Program for the Sun City and Sun City West Water Districts for the CAP surcharges should be approved.

57. Arizona-American should continue the use of its current depreciation rates as recommended by Staff.

58. Staff's proposed water loss reporting and plan requirements are reasonable and should be adopted.

59. Staff's recommendation for the filing of Curtailment Plan Tariffs is reasonable and should be adopted.

60. The fair value rate bases, the fair value rates of return, and the resulting rates and charges for each system as shown in Exhibit A attached hereto and incorporated herein by reference, are just and reasonable and shall be adopted.

CONCLUSIONS OF LAW

1. Arizona-American is a public service corporation within the meaning of Article XV of the Arizona Constitution and A.R.S. Sections 40-250 and 40-241.

2. The Commission has jurisdiction over the Company and the subject matter of the applications.

3. Notice of the applications was provided in the manner prescribed by law.

4. The rates and charges for each system, as shown in Exhibit A attached hereto and

incorporated herein by reference, are just and reasonable and shall be approved.

ORDER

IT IS THEREFORE ORDERED that Arizona-American Water Company, Inc. is hereby directed to file with the Commission on or before June 30, 2004, revised schedules of rates and charges consistent with Exhibit A and the discussion herein, including the change to the Sun City District's Irrigation Water Tariff.

IT IS FURTHER ORDERED that the revised schedules of rates and charges shall be effective for all service rendered on and after July 1, 2004.

IT IS FURTHER ORDERED that Arizona-American Water Company, Inc. shall notify its affected customers of the revised schedules of rates and charges authorized herein by means of an insert in its next regularly scheduled billing, in a form approved by the Commission's Utilities Division Staff.

IT IS FURTHER ORDERED that Arizona-American Water Company, Inc.'s proposed Tolleson Agreement Cost Adjustor Mechanism is not approved at this time.

IT IS FURTHER ORDERED that Arizona-American Water Company, Inc.'s proposed Low Income Program for the Sun City and Sun City West Water Districts for the CAP surcharges is hereby approved.

IT IS FURTHER ORDERED that Arizona-American Water Company, Inc. shall continue the use of its current depreciation rates for the ten Districts.

IT IS FURTHER ORDERED that Arizona-American Water Company, Inc. shall implement the water loss reporting and plan requirements as proposed by the Commission's Utilities Division Staff as described herein within 30 days.

IT IS FURTHER ORDERED that Arizona-American Water Company, Inc. shall file Curtailment Plan Tariffs within 90 days of this Decision.

IT IS FURTHER ORDERED that Arizona-American Water Company, Inc. shall form a Fire-flow Task Force to be comprised of members including, but not limited to, a representative of the company's Arizona management team, representatives from Youngtown and Sun City, a representative of the Sun City's Taxpayers' Association, a representative of the Recreation Centers of

Sun City, and representatives from the fire departments serving Youngtown and Sun City. The purpose of this Task Force shall be to determine if the water production capacity, storage capacity, water lines, water pressure, and fire hydrants of Youngtown and Sun City are sufficient to provide the fire protection capacity that is desired by each community.

IT IS FURTHER ORDERED that the Fire-flow Task Force shall be formed in November 2004.

IT IS FURTHER ORDERED that the Fire-flow Task Force shall submit its findings and proposed plan of action to the Commission no later than May 30, 2005. Those members of the Fire-flow Task Force that do not agree with the findings and proposed plan of action may submit their own findings and proposed plan of action, but must do so by June 30, 2005.

IT IS FURTHER ORDERED that Arizona-American Water Company, Inc. shall work in conjunction with the fire departments serving Youngtown and Sun City to test the fire hydrants in Youngtown and Sun City in order to determine if those hydrants are operational. The Company shall submit a progress report on April 1st of each year to the Commission.

IT IS FURTHER ORDERED that the next rate case filing for the Mohave and Havasu Water Districts shall include a rate design proposal that will complete the move to a simpler, more conventional rate design under which the multi-family residential customers and multi-unit commercial customers in those Districts will pay the minimum charge based upon actual meter size.

IT IS FURTHER ORDERED that Arizona-American Water Company, Inc. shall develop and submit for the approval of Staff a water conservation initiative within 30 days of the effective date of this Decision. Arizona-American Water Company, Inc. shall disseminate its water conservation initiative by bill insert to all customers affected by this Application within 30 days of approval by Staff. Arizona-American Water Company, Inc. shall also continue to post the approved water conservation initiative on its website.

...

...

...

...

IT IS FURTHER ORDERED that the next rate case filings for the Sun City West, Sun City and Anthem/Agua Fria wastewater Districts shall include a rate design proposal that presents information on 1) whether wastewater rates based on water consumption encourage water conservation; 2) whether higher bills for those who use the system more is a fairer way to collect revenue; and 3) what tiered wastewater rates based on water consumption would look like compared to a flat rate design.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN | COMMISSIONER | COMMISSIONER

COMMISSIONER | COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Secretary of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this 30th day of June, 2004.

BRIAN C. McNEIL
EXECUTIVE SECRETARY

DISSENT ________________

DISSENT: ________________
TW:mlj

SERVICE LIST FOR: ARIZONA-AMERICAN WATER COMPANY

DOCKET NO.: WS-01303A-02-0867 et al.

Norman D. James
Jay L. Shapiro
FENNEMORE CRAIG
3003 N. Central Avenue, Ste. 2600
Phoenix, AZ 85012
Attorneys for AZ-American Water Co.

Daniel Pozefsky
RUCO
1110 W. Washington, Ste. 220
Phoenix, AZ 85007

Carlton G. Young
3203 W. Steinbeck Drive
Anthem, Arizona 85068-1540

Frank J. Grimmelmann
42441 N. Cross Timbers Court
Anthem, Arizona 85086

Raymond E. Dare
SUN CITY TAXPAYERS' ASSOCIATION
12611 N. 103rd Avenue, Suite D
Sun City, Arizona 85351-3467

William P. Sullivan
Paul R. Michaud
Paula A. Williams
MARTINEZ & CURTIS
2712 N. 7th Street
Phoenix, Arizona 85006
Attorneys for the Town of Youngtown

Walter W. Meek
AUIA
2100 N. Central Avenue, Suite 210
Phoenix, Arizona 85004

John A. Buric
WARNER ANGLE HALLAM JACKSON & FORMANEK, PLC
3550 North Central Avenue, Ste. 1500
Phoenix, AZ 85012
Attorneys for Fiesta RV Resort Limited Partnership

Kenneth C. Sundlof
Robert R. Taylor
JENNINGS, STRAUSS & SALMON
The Collier Center, 11th Floor
201 East Washington Street
Phoenix, AZ 85004
Attorneys for Sun Health Corporation

Christopher Kempley, Chief Counsel
Legal Division
ARIZONA CORPORATION COMMISSION
1200 West Washington Street
Phoenix, Arizona 85007

Ernest Johnson, Director
Utilities Division
ARIZONA CORPORATION COMMISSION
1200 West Washington Street
Phoenix, Arizona 85007

ARIZONA AMERICAN
Docket No. WS-01303A-02-0867 et. al.
TEST YEAR ENDED DECEMBER 31, 2001

		SUN CITY WEST WATER						
			Tier One		Tier Two		Tier Three	
		Monthly Usage Charge:	Commodity Rate	Upper Limit	Commodity Rate	Second Tier Breakover	Commodity Rate	Second Tier Breakover
Residential, Commercial, Irrigation, Resale and Miscellaneous Customers								
Residential 5/8-inch	Meter	$ 5.87	$ 0.8500	4,000	$ 1.2850	15,000	$ 1.5510	Infinite
Residential 3/4-inch	Meter	5.87	0.8500	4,000	1.2850	15,000	1.5510	Infinite
Commercial 5/8-inch	Meter	5.87	1.2850	15,000	1.5510	Infinite	-	-
Commercial 3/4-inch	Meter	5.87	1.2850	15,000	1.5510	Infinite	-	-
1-inch	Meter	14.97	1.2850	40,000	1.5510	Infinite	-	-
1.5-inch	Meter	32.08	1.2850	100,000	1.5510	Infinite	-	-
2-inch	Meter	47.05	1.2850	150,000	1.5510	Infinite	-	-
3-inch	Meter	81.26	1.2850	275,000	1.5510	Infinite	-	-
4-inch	Meter	120.82	1.2850	400,000	1.5510	Infinite	-	-
6-inch	Meter	165.73	1.2850	550,000	1.5510	Infinite	-	-
8-inch	Meter	374.23	1.2850	1,300,000	1.5510	Infinite	-	-
10-inch	Meter	-	-	-	-	-	-	-
12-inch	Meter	-	-	-	-	-	-	-
General Fire Sprinkler Rate								
4-inch	Meter	35.22	$ 1.09	Infinite	-	-	-	-
6-inch	Meter	52.84	1.09	Infinite	-	-	-	-
8-inch	Meter	70.45	1.09	Infinite	-	-	-	-
10-inch	Meter	131.72	1.09	Infinite	-	-	-	-
Construction/Untreated CAP		-	$ 0.5488	Infinite	-	-	-	-
Effluent Sales, Per Acre Foot			$ 164.6475	-	-	-	-	-

ARIZONA AMERICAN
Docket No. WS-01303A-02-0867 et. al.
TEST YEAR ENDED DECEMBER 31, 2001

	SUN CITY WEST WASTEWATER				
		Monthly Usage Charge:	Gallons Included		Commodity Charge Per Thousand Gallons

Note: Charges are applied up to the usage indicated in the schedules. Amounts in excess of the first tier have no charges.

Residential Units (WSR)	$	20.56	-	$	-
Commerical (SSC)	$	29.25	-		-
Comm. Large User (SS6)	$	57.50	20,000		1.2500
Multi-family Res. Units (AC SSR)	$	20.57	-		-
Comm. additional toilets (WS1)	$	6.72	-		-
Comm. per dishwasher (WS2)	$	53.91	-		-
Comm. per wash mach. (WS3)	$	12.58	-		-
Comm. per wash rack (WS4)	$	26.35	-		-

Annual Fee for Industrial Discharge Service
Non-refundable annual fee assessed in advance each January by special billing to industrial customers. Gallonage applies to total gallonage through all meters, inclusive of meters used for irrigation.

Industrial Discharge Annual Fee* <50,000gal/mo.	$	500.00
Industrial Discharge Annual Fee* >50,000gal/mo.	$	1,000.00

DECISION NO. 67093

ARIZONA AMERICAN
Docket No. WS-01303A-02-0867 et. al.
TEST YEAR ENDED DECEMBER 31, 2001

SUN CITY WATER

			Tier One		Tier Two		Tier Three	
		Monthly Usage Charge:	Commodity Rate	Upper Limit	Commodity Rate	Second Tier Breakover	Commodity Rate	Second Tier Breakover
Residential, Commercial, Irrigation, Resale and Miscellaneous Customers								
Residential 5/8-inch	Meter	$ 6.33	$ 0.7200	4,000	$ 1.1000	18,000	$ 1.3160	Infinite
Residential 3/4-inch	Meter	6.33	0.7200	4,000	1.1000	18,000	1.3160	Infinite
Commercial 5/8-inch	Meter	6.33	1.1000	18,000	1.3160	Infinite	-	-
Commercial 3/4-inch	Meter	6.33	1.1000	18,000	1.3160	Infinite	-	-
1-inch	Meter	16.40	1.1000	60,000	1.3160	Infinite	-	-
1.5-inch	Meter	33.77	1.1000	125,000	1.3160	Infinite	-	-
2-inch	Meter	51.14	1.1000	190,000	1.3160	Infinite	-	-
3-inch	Meter	86.84	1.1000	340,000	1.3160	Infinite	-	-
4-inch	Meter	135.00	1.1000	550,000	1.3160	Infinite	-	-
6-inch	Meter	178.51	1.1000	700,000	1.3160	Infinite	-	-
8-inch	Meter	350.00	1.1000	1,450,000	1.3160	Infinite	-	-
10-inch	Meter	-	-	-				
12-inch	Meter	-	-	-				
Irrigation								
1-inch	Meter	16.46	0.8200	Infinite	-	-	-	-
1.5-inch	Meter	33.78	0.8200	Infinite	-	-	-	-
2-inch	Meter	51.15	0.8200	Infinite	-	-	-	-
3-inch	Meter	86.87	0.8200	Infinite	-	-	-	-
4-inch	Meter	135.00	0.8200	Infinite	-	-	-	-
6-inch	Meter	178.56	0.8200	Infinite	-	-	-	-
8-inch	Meter	-	-	-	-	-	-	-
Public Interruptible								
3-inch	Meter	4.59	0.6300	Infinite	-	-	-	-
8-inch	Meter	4.59	0.6300	Infinite	-	-	-	-
Private Fire								
3-inch	Meter	7.60	0.7600	Infinite	-	-	-	-
4-inch	Meter	11.39	0.7600	Infinite	-	-	-	-
6-inch	Meter	15.83	0.7600	Infinite	-	-	-	-
8-inch	Meter	25.32	0.7600	Infinite	-	-	-	-
10-inch	Meter	39.35	0.7600	Infinite	-	-	-	-
Standby Rates		4.62	0.7600	Infinite	-	-	-	-
Construction/Untreated CAP		-	0.6558	Infinite	-	-	-	-

ARIZONA AMERICAN
Docket No. WS-01303A-02-0867 et. al.
TEST YEAR ENDED DECEMBER 31, 2001

	Monthly Usage Charge:	Gallons Included	Commodity Charge Per 1,000 Gallons
	SUN CITY WASTEWATER		

Note: Charges are applied up to the usage indicated in the schedules. Amounts in excess of the first tier have no charges.

	Monthly Usage Charge:	Gallons Included	Commodity Charge Per 1,000 Gallons
Residential Units (SSR)	$ 10.98	-	$ -
Comm/Resid Units (SSR)	$ 10.98	-	-
Commerical	$ 13.18	-	-
Comm. Large User (SS6)	$ 27.95	20,000	$ 1.07
Multi-family Res. Units (AC SSR)	$ 10.98	-	-
Comm. additional toilets (SS1)	$ 3.25	-	-
Comm. per dishwasher (SS2)	$ 24.79	-	-
Comm. per wash mach. (SS3)	$ 6.03	-	-
Comm. per wash rack (SS4)	$ 12.27	-	-
Rental Rooms/ Paradise Resort Park (Contract Rate)	$ 3.94	20,000	$ 0.91

Annual Fee for Industrial Discharge Service
Non-refundable annual fee assessed in advance each January by special billing to industrial customers. Gallonage applies to total gallonage through all meters, inclusive of meters used for irrigation.

Industrial Discharge Annual Fee* <50,000gal/mo.	$ 500.00
Industrial Discharge Annual Fee* >50,000gal/mo.	$ 1,000.00

ARIZONA AMERICAN
Docket No. WS-01303A-02-0867 et. al.
TEST YEAR ENDED DECEMBER 31, 2001

MOHAVE WATER

			Monthly Usage Charge:	Tier One Commodity Rate	Tier One Upper Limit	Tier Two Commodity Rate	Tier Two Second Tier Breakover	Tier Three Commodity Rate	Tier Three Second Tier Breakover
Residential, Commercial, Irrigation, Resale and Miscellaneous Customers									
Residential 5/8-inch	Meter		$7.80	$ 0.8000	4,000	$ 1.1900	18,000	$ 1.4350	Infinite
Residential 3/4-inch	Meter		7.80	0.8000	4,000	1.1900	18,000	1.4350	Infinite
Commercial 5/8-inch	Meter		7.80	1.1900	18,000	1.4350	Infinite	-	-
Commercial 3/4-inch	Meter		N/A	-	-	-	-	-	-
1-inch	Meter		13.95	1.1900	35,000	1.4350	Infinite	-	-
1.5-inch	Meter		22.53	1.1900	65,000	1.4350	Infinite	-	-
2-inch	Meter		26.82	1.1900	75,000	1.4350	Infinite	-	-
3-inch	Meter		54.18	1.1900	175,000	1.4350	Infinite	-	-
4-inch	Meter		81.00	1.1900	270,000	1.4350	Infinite	-	-
6-inch	Meter		180.25	1.1900	635,000	1.4350	Infinite	-	-
8-inch	Meter		360.50	1.1900	1,250,000	1.4350	Infinite	-	-
10-inch	Meter		624.43	1.1900	2,200,000	1.4350	Infinite	-	-
Residential and Commercial Multi Family and Multi Unit									
5/8-inch	Meter	$7.80 X No. Of Units X 1/2*		1.1900	18,000	1.4350	Infinite	-	-
1-inch	Meter	$7.80 X No. Of Units X 1/2*		1.1900	35,000	1.4350	Infinite	-	-
1.5-inch	Meter	$7.80 X No. Of Units X 1/2*		1.1900	65,000	1.4350	Infinite	-	-
2-inch	Meter	$7.80 X No. Of Units X 1/2*		1.1900	75,000	1.4350	Infinite	-	-
4-inch	Meter	$7.80 X No. Of Units X 1/2*		1.1900	270,000	1.4350	Infinite	-	-
6-inch	Meter	$7.80 X No. Of Units X 1/2*		1.1900	635,000	1.4350	Infinite	-	-
*Minimum charge will not be below $7.80									
RIO VERDE 5/8-inch Meter			6.99	0.8000	4,000	1.1900	18,000	1.4350	Infinite
RIO VERDE 1-inch Meter			6.99	1.1900	35,000	1.4350	Infinite	-	-
RIO VERDE 2-inch Meter			6.99	1.1900	75,000	1.4350	Infinite	-	-
Public Authority									
5/8-inch	Meter		7.80	1.1783	Infinite	-	-	-	-
1-inch	Meter		13.95	1.1783	Infinite	-	-	-	-
1.5-inch	Meter		22.53	1.1783	Infinite	-	-	-	-
2-inch	Meter		26.82	1.1783	Infinite	-	-	-	-
3-inch	Meter		54.18	1.1783	Infinite	-	-	-	-
4-inch	Meter		81.00	1.1783	Infinite	-	-	-	-
6-inch	Meter		180.25	1.1783	Infinite	-	-	-	-
8-inch	Meter		360.50	1.1783	Infinite	-	-	-	-
10-inch	Meter		624.43	1.1783	Infinite	-	-	-	-
Private Fire									
2-inch	Meter		2.74	1.1783	Infinite	-	-	-	-
3-inch	Meter		N/A						
4-inch	Meter		5.48	1.1783	Infinite	-	-	-	-
6-inch	Meter		8.22	1.1783	Infinite	-	-	-	-
8-inch	Meter		10.96	1.1783	Infinite	-	-	-	-
10-inch	Meter		13.70	1.1783	Infinite	-	-	-	-
12-inch	Meter		15.12	1.1783	Infinite	-	-	-	-
14-inch	Meter		17.65	1.1783	Infinite	-	-	-	-
20-inch	Meter		25.21	1.1783	Infinite	-	-	-	-
PF Hydrant			26.82	1.1900	75,000	1.4350	Infinite	-	-
Standby Rates			6.98	1.1783	Infinite	-	-	-	-
Per Sprinkler Head			0.43	-	-	-	-	-	-

ARIZONA AMERICAN
Docket No. WS-01303A-02-0867 et. al.
TEST YEAR ENDED DECEMBER 31, 2001

		HAVASU WATER						
			Tier One		Tier Two		Tier Three	
		Monthly Usage Charge:	Commodity Rate	Upper Limit	Commodity Rate	Second Tier Breakover	Commodity Rate	Second Tier Breakover
Residential, Commercial, Irrigation, Resale and Miscellaneous Customers								
Residential 5/8-inch	Meter	$11.78	$ 1.0500	4,000	$ 1.5550	13,000	$ 1.8700	Infinite
Residential 3/4-inch	Meter	N/A						
Commercial 5/8-inch	Meter	11.78	1.5550	13,000	1.8700	Infinite		
Commercial 3/4-inch	Meter	N/A						
1-inch	Meter	20.27	1.5550	30,000	1.8700	Infinite		
1.5-inch	Meter	28.76	1.5550	45,000	1.8700	Infinite		
2-inch	Meter	39.88	1.5550	60,000	1.8700	Infinite		
3-inch	Meter	54.26	1.5550	90,000	1.8700	Infinite		
4-inch	Meter	68.64	1.5550	110,000	1.8700	Infinite		
6-inch	Meter	236.59	1.5550	500,000	1.8700	Infinite		
8-inch	Meter	457.50	1.5550	1,000,000	1.8700	Infinite		
10-inch	Meter	N/A						
12-inch	Meter	N/A						
Multi-family 044 1"		259.16	1.5550	30,000	1.8700	Infinite		
Multi-family 056 2"		329.84	1.5550	60,000	1.8700	Infinite		
Multi-family 064 4"		376.96	1.5550	110,000	1.8700	Infinite		
Multi-family 065 2"		382.85	1.5550	60,000	1.8700	Infinite		
Multi-family 067 4"		394.63	1.5550	110,000	1.8700	Infinite		
Multi-family 089 1"		524.21	1.5550	30,000	1.8700	Infinite		
Multi-family 102 2"		600.78	1.5550	60,000	1.8700	Infinite		
Multi-family 129 4"		759.81	1.5550	110,000	1.8700	Infinite		
Multi-family 153 4"		901.17	1.5550	110,000	1.8700	Infinite		

DECISION NO. 67093

ARIZONA AMERICAN
Docket No. WS-01303A-02-0867 et. al.
TEST YEAR ENDED DECEMBER 31, 2001

AGUA FRIA WATER

		Monthly Usage Charge:	Tier One Commodity Rate	Tier One Upper Limit	Tier Two Commodity Rate	Tier Two Second Tier Breakover	Tier Three Commodity Rate	Tier Three Second Tier Breakover
Residential, Commercial, Irrigation, Resale and Miscellaneous Customers								
Residential 5/8-inch	Meter	$ 9.08	$ 1.3800	4,000	$ 2.0600	13,000	$ 2.4870	Infinite
Residential 3/4-inch	Meter	9.08	1.3800	4,000	2.0600	13,000	2.4870	Infinite
Commercial 5/8-inch	Meter	9.08	2.0600	13,000	2.4870	Infinite		
Commercial 3/4-inch	Meter	9.08	2.0600	13,000	2.4870	Infinite		
1-inch	Meter	23.24	2.0600	45,000	2.4870	Infinite		
1.5-inch	Meter	48.58	2.0600	100,000	2.4870	Infinite		
2-inch	Meter	72.86	2.0600	150,000	2.4870	Infinite		
3-inch	Meter	142.55	2.0600	300,000	2.4870	Infinite		
4-inch	Meter	191.75	2.0600	400,000	2.4870	Infinite		
6-inch	Meter	369.55	2.0600	800,000	2.4870	Infinite		
8-inch	Meter	726.26	2.0600	1,500,000	2.4870	Infinite		
Public Interruptible								
2-inch	Meter		1.0000	Infinite				
3-inch	Meter		1.0000	Infinite				
6-inch	Meter		1.0000	Infinite				
8-inch	Meter		1.0000	Infinite				
10-inch	Meter		1.0000	Infinite				
Prison 4"	Meter	191.75	1.9300	Infinite				
Private Fire								
4-inch	Meter	27.25	1.3800	Infinite				
6-inch	Meter	40.86	1.3800	Infinite				
8-inch	Meter	54.48	1.3800	Infinite				
10-inch	Meter	108.96	1.3800	Infinite				
12-inch	Meter	163.44	1.3800	Infinite				
Construction			1.0000	Infinite				
Untreated CAP		Cancelled						

DECISION NO. 67093

ARIZONA AMERICAN
Docket No. WS-01303A-02-0867 et. al.
TEST YEAR ENDED DECEMBER 31, 2001

		ANTHEM WATER						
			Tier One		Tier Two		Tier Three	
		Monthly Usage Charge:	Commodity Rate	Upper Limit	Commodity Rate	Second Tier Breakover	Commodity Rate	Second Tier Breakover
Residential, Commercial, Irrigation, Resale and Miscellaneous Customers								
Residential 5/8-inch	Meter	$15.00	$ 1.1300	4,000	$ 1.7000	18,000	$ 2.0400	Infinite
Residential 3/4-inch	Meter	15.00	1.1300	4,000	1.7000	18,000	2.0400	Infinite
Residential 1-inch	Meter	26.42	1.1300	4,000	1.7000	40,000	2.0400	Infinite
Commercial 5/8-inch	Meter	15.00	1.7000	18,000	2.0400	Infinite		
Commercial 3/4-inch	Meter	15.00	1.7000	18,000	2.0400	Infinite		
1-inch	Meter	26.42	1.7000	40,000	2.0400	Infinite		
1.5-inch	Meter	60.78	1.7000	125,000	2.0400	Infinite		
2-inch	Meter	79.29	1.7000	175,000	2.0400	Infinite		
3-inch	Meter	151.97	1.7000	375,000	2.0400	Infinite		
4-inch	Meter	375.00	1.7000	500,000	2.0400	Infinite		
6-inch	Meter	1,200.00	1.7000	600,000	2.0400	Infinite		
8-inch	Meter	1,725.00	1.7000	1,400,000	2.0400	Infinite		
10-inch	Meter							
12-inch	Meter							
Irrigation								
1-inch	Meter		0.62	Infinite				
1.5-inch	Meter		0.62	Infinite				
2-inch	Meter		0.62	Infinite				
3-inch	Meter		0.62	Infinite				
4-inch	Meter		0.62	Infinite				
8-inch	Meter		0.62	Infinite				
Public Interruptible								
2-inch	Meter	-	2.16	Infinite				
3-inch	Meter	-	2.16	Infinite				
6-inch	Meter	-	2.16	Infinite				
10-inch	Meter	-	2.16	Infinite				
Private Fire								
3-inch	Meter	$49.67	Flat Rates	Infinite				
4-inch	Meter	84.40	Flat Rates	Infinite				
6-inch	Meter	126.60	Flat Rates	Infinite				
8-inch	Meter	127.72	Flat Rates	Infinite				
10-inch	Meter	255.45	Flat Rates	Infinite				

ARIZONA AMERICAN
Docket No. WS-01303A-02-0867 et. al.
TEST YEAR ENDED DECEMBER 31, 2001

ANTHEM/AGUA FRIA WASTEWATER DISTRICT		Monthly Usage Charge:	Gallons Included		Commodity Charge Per Thousand Gallons

Note: Charges are applied up to the usage indicated in the schedules. Amounts in excess of the first tier have no charges.

Residential Units	$	20.30	7,000	$	2.5450
Small Commerical User 5/8"		20.30	10,000	$	2.5450
Small Commerical User 3/4"		30.48	15,000	$	2.5450
Small Commerical User 1"		40.64	20,000	$	2.5450
Comm. Large User		81.26	999,999,999	$	2.5450
Anthem/Agua Fria Treatco		-	999,999,999	$	2.3200

Annual Fee for Industrial Discharge Service
Non-refundable annual fee assessed in advance each January by special billing to industrial customers. Gallonage applies to total gallonage through all meters, inclusive of meters used for irrigation.

Industrial Discharge Annual Fee* <50,000gal/mo.	500.00
Industrial Discharge Annual Fee* >50,000gal/mo.	1,000.00

ARIZONA AMERICAN
Docket No. WS-01303A-02-0867 et. al.
TEST YEAR ENDED DECEMBER 31, 2001

			Tier One		Tier Two		Tier Three	
		TUBAC WATER						
		Monthly Usage Charge:	Commodity Rate	Upper Limit	Commodity Rate	Second Tier Breakover	Commodity Rate	Second Tier Breakover
Residential, Commercial, Irrigation, Resale and Miscellaneous Customers								
Residential 5/8-inch	Meter	$19.68	$ 1.8900	4,000	$ 2.8500	20,000	$ 3.4100	Infinite
Residential 3/4-inch	Meter	19.68	1.8900	4,000	2.8500	20,000	3.4100	Infinite
Commercial 5/8-inch	Meter	19.68	2.8500	20,000	3.4100	Infinite		
Commercial 3/4-inch	Meter	19.68	2.8500	20,000	3.4100	Infinite		
1-inch	Meter	29.63	2.8500	35,000	3.4100	Infinite		
1.5-inch	Meter	59.26	2.8500	85,000	3.4100	Infinite		
2-inch	Meter	97.49	2.8500	150,000	3.4100	Infinite		
3-inch	Meter	115.65	2.8500	175,000	3.4100	Infinite		
4-inch	Meter	169.18	2.8500	250,000	3.4100	Infinite		
6-inch	Meter	231.30	2.8500	350,000	3.4100	Infinite		
8-inch	Meter	1,577.08	2.8500	900,000	3.4100	Infinite		

DECISION NO. 67093